TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, [redacted] 1926

No. [redacted] 108

CHARLES V. DUFFY, FORMER COLLECTOR OF INTERNAL REVENUE, PETITIONER

vs.

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED MAY 11, 1926.
CERTIORARI GRANTED JUNE 1, 1926.

(31168)

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1924.

No. 1203

CHARLES V. DUFFY, FORMER COLLECTOR OF INTERNAL REVENUE, PETITIONER

vs.

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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In United States District Court District of New Jersey

MUTUAL BENEFIT LIFE INSURANCE COMPANY vs. CHARLES V. DUFFY, COLLECTOR OF INTERNAL revenue for the Fifth District of New Jersey	At law, No. 2618

Docket entries

July 24, 1920	Petition for removal by certiorari filed.
" " "	Order allowing writ of certiorari filed.
" " "	Writ of certiorari issued.
" 29, "	Return to writ of certiorari filed.
Nov. 18, "	Amended complaint filed.
" 22, "	Motion to strike out complaint filed.
July 21, 1921	Order amending complaint filed.
Apr. 30, 1923	Order amending complaint filed.
May 9, "	Amended complaint filed.
Feb. 4, 1924	Order amending complaint filed.
" 19, "	Opinion filed.
" 26, "	Order denying motion to strike out complaint and for judgment filed.
Mar. 5, "	Certificate of probable cause filed.
Apr. 17, "	Order extending time to file bill of exceptions filed.
" 28, "	Exceptions filed.
" " "	Assignments of error filed.
" " "	Petition for writ of error filed.
" " "	Order allowing writ of error filed.
" " "	Writ of error issued; copy filed.
" " "	Citation issued.
May 5, "	Citation returned; service acknowledged; copy filed.

2 In United States District Court

[Title omitted.]

Amended complaint

The plaintiff, a corporation duly organized under the laws of the State of New Jersey and having its principal office and place of business in the city of Newark in said State, says that:

1. Plaintiff was incorporated and continues as a mutual life insurance company by charter granted by the State of New Jersey in

1845 which provided "that all persons who shall at any time hereafter insure in or with the said association shall, while they continue so insured, be deemed and taken as members of the said corporation; and that the property and concerns of the said corporation shall be conducted and managed by twelve directors * * * to be chosen, by ballot, by and from among the members" and "that it shall and may be lawful for the said corporation to insure their
respective lives, and to make all and every insurance ap-
3 pertaining to or connected with life risks of whatever kind or
nature. It is a mutual company. It has no capital stock and no stockholders. It never has been and is not now engaged in any other business than that of mutual life insurance. A copy of the plaintiff's charter and of its by-laws as they were on January 1, 1917, marked Exhibit No. 1, is hereto annexed and made part hereof.

2. The plaintiff's assets have all been contributed by its members in the form of premiums on policy contracts. A statement of the total receipts and disbursements on account of these since the incorporation of the plaintiff, and the balance remaining December 31, 1916, and used in its business during the year 1917, is shown on Schedule A hereto annexed and made part hereof.

Its assets are invested in its office building and in Government, municipal, railroad, and utility bonds, bonds secured by mortgages on real estate, and loans to policyholders and on collateral, and in foreclosed real estate, as is shown in Schedule B hereto annexed and by reference made part hereof. The average rate of interest or return on its invested assets is and for many years has been less than six per cent per annum. None of its assets during the year 1917 yielded an income in excess of six per centum per annum. A tabulation of the interest so received during the year 1917 is hereto annexed as Schedule C and made part hereof.

3. The plaintiff is a purely mutual company and has always conducted its business of life insurance on what is generally known as the "level premium plan" as distinguished from the "pure-assessment plan" under which the loss payable on the death of a member is, after the event, contributed pro rata by the surviving members, and from the "natural-premium plan" under which each member
contributes each year the cost of carrying his insurance for
4 that year, which cost increases yearly as his age increases.
Under the level-premium plan the estimated annual cost of each member's insurance is averaged and the maximum annual contribution which he can be called upon to make is uniform throughout the life of the policy. The member contributes annually during his early years a sum in excess of the natural premium. Such excess contributions augmented by interest thereon are held by the company as a reserve which serves to maintain his insurance in his later years when the stipulated level premium would otherwise be insufficient to meet the current cost of insurance. (An exhibit showing a comparison of natural and level premiums and the annual increase in

the reserve is hereto annexed as Schedule D and made part hereof.) The premiums referred to above are the "net" or mathematical premiums without any provision for expenses or contingencies, which are met out of an addition to the net premium called "loading." The net or mathematical premium increased by the loading constitutes the premium rate stipulated in the policy of insurance. At the end of each year the excess of income over disbursements is ascertained, and, after setting aside so much of said excess as is required by law for the increase in policy reserves, each policyholder's share in the balance is ascertained and returned to him, either in cash or by credit upon his next annual premium, as he may elect.

4. The laws of the State of New Jersey and of all other States in which the plaintiff is doing business require, as a condition precedent to the continued transaction of business of a life insurance company, that its assets shall not be less than the reserve required by law. In the plaintiff's management of its assets there is no segregation or special allocation of any part thereof. They constitute one general fund. The reserve is not earmarked or separately invested. The interest earned on all securities not specifically exempt from
5 tax is included in plaintiff's returns of gross income for Federal income-tax purposes.

5. The amount of reserve for which the plaintiff is required to hold assets is computed annually by the commissioner of banking and insurance of the State of New Jersey. His certificate is accepted by the insurance commissioners of all other States in which the plaintiff does business, with the exception of the insurance commissioner of Massachusetts, who makes an independent calculation.

In computing life insurance reserves two methods are used. They produce the same results. Both are based upon an assumed rate of mortality and an assumed rate of interest. One is known as the "retrospective method," because it deals with what has occurred in the past on the basis of these assumptions. The other is known as the "prospective method," because it deals with what is expected to occur in the future on the basis of the same assumptions. They are illustrated in Schedule E hereto annexed and made part hereof.

6. The reserve required by law as computed by the commissioner of banking and insurance of the State of New Jersey was on January 1, 1909, the sum of $110,124,750.07, and on January 1, 1913, was $144,153,942.69. On January 1, 1917, it was $186,258,796.00. As computed by the Massachusetts insurance department, the reserve was as follows: On January 1, 1909, $110,080,452.07; on January 1, 1913, $143,393,732.69; on January 1, 1917, $185,638,632.00.

The net addition made each year to the plaintiff's reserve from the date of its incorporation to December 31, 1917, and the minimum part thereof that was derived each year from premiums paid by the policyholders, and the maximum part thereof that was derived each year from interest earned on its reserve, with the total of the
6 reserve at the end of each year, is correctly set forth in Schedule F hereto annexed and hereby made a part of this com-

plaint, as well as the total of such premium contributions, and such interest contributions at the end of the years 1908, 1910, 1911, 1912, 1916, and 1917; and, in particular, plaintiff says, that its reserve required by law on January 1, 1909, was the sum of $110,124,750.07, of which sum not less than $33,569,857.14 consisted of premiums paid in by its policyholders and not more than $76,554,892.93 consisted of interest earned on the investment of its reserve; plaintiff's reserve on January 1, 1911, was $125,154,485.70, of which sum not less than $39,979,811.50 consisted of premiums paid in by its policyholders, and not more than $85,174,674.20 consisted of interest earned on the investment of its reserve; plaintiff's reserve on January 1, 1912, was $135,464,075.15, of which sum not less than $45,591,484.45 consisted of premiums paid in by its policyholders, and not more than $89,872,590.70 consisted of interest earned on the investment of its reserve; plaintiff's reserve on January 1, 1913, was $144,153,942.69, of which sum not less than $49,610,074.71 consisted of premiums paid in by its policyholders, and not more than $94,543,867.98 consisted of interest earned on the investment of its reserve; plaintiff's reserve on January 1, 1917, was $186,258,796.00, of which sum not less than $70,302,157.10 consisted of premiums paid in by its policyholders, and not more than $115,956,638.90 consisted of interest earned on the investment of its reserve; plaintiff's reserve on January 1, 1918, was $200,815,927.00, of which sum not less than $78,638,717.11 consisted of premiums paid in by its policyholders, and not more than $122,177,209.89 consisted of interest earned on the investment of its reserve.

7 7. A policyholder of the plaintiff, while he continues a member of the company, has no right to withdraw any part of the reserve. On ceasing to be a member of the company and surrendering his policy for cancellation he may, ordinarily, at his option, receive a certain sum in cash or in paid-up policy in reduced amount or extended insurance for the full amount for a limited period. Any allowance thus made is never in excess of the reserve. It is generally less, and in some circumstances no allowance at all is made.

8. The defendant was at all times hereinafter mentioned and still is collector of internal revenue for the fifth district of New Jersey.

9. The defendant, by virtue of his said office and assuming to act under the statutes of the United States and more especially under the act of Congress of the United States entitled "An act to provide revenue, to defray war expenses, and for other purposes," approved October 3, 1917, and under Title II thereof, relating to the war excess profits tax, did unlawfully demand of, and by force and duress, collect from the said plaintiff, for war excess profits taxes for the taxable year 1917 the sum of $83,779.70 on the 18th day of June, 1920.

10. The plaintiff involuntarily and under duress and threats of penalties and distraint against its property in case of its refusal to pay said sum was compelled to and did pay to said defendant said

sum at the time aforesaid, then protesting that it was not liable to pay the same or any part thereof, and that the said tax was erroneously, illegally, and wrongfully assessed and collected.

11. The assessment and collection of said tax was illegal for the following reason:

In determining the liability of the plaintiff to pay such tax, and the amount thereof, defendant computed plaintiff's invested capital for the year 1917 at $14,719,043.76, and allowed the plaintiff
8 under the provisions of section 203 (a) (1) of the revenue act of 1917 as a deduction from its net income for the year 1917 a sum equal to 9 per cent of $14,719,043.76—namely, $1,324,713.94. Defendant refused to permit the plaintiff to include as part of its invested capital in addition to the sum of $14,719,043.76 the reserve of $186,258,796.00 held by the plaintiff as required by law for the fulfillment of its obligations upon its outstanding policy contracts, and plaintiff claims that by reason thereof it was not allowed the full deduction provided for in section 203 (a) (1) of said law. If this reserve of $186,258,796.00 had been allowed as part of plaintiff's invested capital, no war excess profits tax would have been due.

If on any computation plaintiff's invested capital had been ascertained at a sum in excess of $25,500,000.00, no war excess profits tax would have been due.

12. In further explanation of its claim that said tax was unlawfully assessed and collected, the plaintiff says that:

In pursuance of Title II of the act of Congress of October 3, 1917, imposing a war excess profits tax, plaintiff duly filed its return for the year 1917, showing that under plaintiff's construction of the act it was not subject to a war excess profits tax for the year 1917.

Plaintiff's return of net income for the year 1917 made in pursuance of Title I of the act of Congress of September 8, 1916, as amended, showed a net income of $1,808,339.33, on which it paid an income tax of $108,500.36.

Afterwards, on June 10, 1920, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, amended the income tax and war excess profits tax returns of the plaintiff for the year 1917 in the several respects set forth below and thereupon levied an assessment against the plaintiff for the year 1917 amounting to $83,779.70.

9 The amendments so made of plaintiff's returns for the year 1917 were as follows:

1. Plaintiff's net income was reduced from $1,808,339.33 to $1,781,815.64, or by the sum of	$26,523.69
2. Plaintiff's invested capital for the taxable year was reduced from $202,685,846.45 to $14,719,043.76, as follows:	
(a) Various adjustments of which plaintiff does not complain reduced the invested capital for the taxable year by the sum of	$1,708,006.69
(b) Plaintiff's invested capital for the taxable year was further reduced by the amount of the policy reserve required for the fulfillment of plaintiff's existing policy contracts, said reserve amounting to	$186,258,796.00

3. Plaintiff did not set forth in its war excess profits tax return the pre-war invested capital or the pre-war net income, and in consequence thereof claimed the minimum deduction of 7% of the invested capital for the taxable year. In amending plaintiff's return $10,115,170.28 was allowed as invested capital for 1911, $8,988,187.41 for 1912, and $9,869,230.99 for 1913. The average was $9,657,529.56. In determining the invested capital thus allowed the policy reserve required for the fulfillment of plaintiff's existing policy contracts was
10 excluded. Said reserve was $124,998,938.70 for 1911, $135,338,211.15 for 1912, and $144,037,583.69 for 1913. The average pre-war taxable income was $869,678.46 or 9.005% of what was allowed as invested capital. The percentage of invested capital to be used by the plaintiff in ascertaining the amount to be deducted from the net income of the taxable year for war excess profits tax purposes was therefore increased from 7% to 9%.

4. In consequence of the above adjustments plaintiff was

assessed with an income tax of	$101,459.72
And a war excess profits tax of	890,820.34
Making in all	$192,280.06
The original tax paid was	$108,500.36
The additional tax demanded and paid was	883,779.70

for the recovery of which this suit is brought.

The aforesaid deduction from plaintiff's invested capital for the taxable year of the sum of $186,258,796, representing the reserve required for the fulfillment of the plaintiff's existing policy contracts, is the basis of plaintiff's complaint.

Plaintiff hereto annexes as Schedule G, and hereby makes a part of this complaint, a copy of its income tax return for the year 1917, omitting detailed schedules, showing the changes made therein by the Commissioner of Internal Revenue; also as Schedule H, a copy of plaintiff's war excess profits tax return for the year 1917, showing the changes made therein by the Commissioner
11 of Internal Revenue as aforesaid; and also, as Schedule I, a detailed statement of the changes in plaintiff's tax returns described above; and also, as Schedule J, a comparative statement of income and deductions and net income shown on the income tax returns as filed by the Mutual Benefit Life Insurance Company and as adjusted by the Internal Revenue Department for the years 1911 to 1918, both inclusive, and showing in two additional columns for the years 1917 and 1918 what the returns for those years would have been if made on the same basis as the previous years, omitting certain self-balancing bookkeeping items which plaintiff was required by the Government to include in its returns for the years 1917 and 1918, but which were not required to be included in the returns for the previous years.

13. The plaintiff, on the 22d day of June, 1920, duly demanded from said defendant the repayment of said sum of money, with interest, because of said illegality and wrongful assessment and collection; and repayment thereof was refused by said defendant.

14. The plaintiff on the 23d day of June, 1920, pursuant to the act of Congress in such case made and provided, caused an appeal to

be made to the Commissioner of Internal Revenue, according to the provisions of law in that regard and the regulations of the Secretary of the Treasury established in pursuance thereof; and the said appeal was, on the 23d day of June, 1920, decided and disallowed by the said commissioner, and no part of said money so paid by plaintiff has been refunded.

Plaintiff demands as damages $83,779.70, with interest thereon from June 18, 1920.

PITNEY, HARDIN & SKINNER,
Attorneys for Plaintiff.

12 *Exhibits to amended complaint*

SCHEDULE A

Since organization and up to December 31, 1916, the contributions (premiums) of the members of the plaintiff corporation amounted to		$515,941,896.66
The amount returned to the members of the corporation, including dividends applied in reduction of the above premiums, amounted to	$393,056,658.53	
The expenses of management amounted to	90,032,445.11	
	483,089,103.64	
The interest and other earnings amounted to	165,860,038.15	
Amount returned to members of the corporation and used for expenses of management in excess of the interest and other earnings	317,229,065.49	317,229,065.49
Actual cash paid in by the members of the corporation from the date of its organization to December 31, 1916, and the balance then remaining and used in its business during the year beginning January 1, 1917		198,712,831.17

13 SCHEDULE B

Schedule of plaintiff's assets December 31, 1916

Cash on hand and in banks	$3,418,528.80
Loans on collateral	3,100,000.00
United States and other bonds (includes State and municipal bonds to the extent only of $4,171,901.33)	55,028,340.71
First bonds and mortgages on real estate	96,167,300.00
Real estate	2,874,753.15
Loans on policies in force	38,102,183.77
Agents' balances	5,569.11
Railroad stock acquired in reorganization	17,250.00
	*198,713,925.54

December 31, 1917

Cash on hand and in banks	$4,238,727.23
Loans on collateral	2,800,000.00
Liberty loan bonds	3,927,500.00
Other bonds (includes State and municipal bonds to the extent only of $4,239,901.33)	54,970,822.99
First bonds and mortgages on real estate	106,345,221.05

* Includes $1,094.37 income taxes "withheld at source" during 1916 and paid in 1917.

Real estate	$2,859,938.81
Loans on policies in force	39,642,904.30
Agents' balances	6,232.27
Railroad stock acquired in reorganization	17,250.00
	214,808,596.65

14 SCHEDULE C

During the calendar year 1917 the plaintiff received interest as follows:

On cash in banks	882,616.87
On loans on collateral	106,487.94
On United States and other bonds (includes interest on State and municipal bonds to the extent only of $175,246.14)	2,471,552.30
On first bonds and mortgages on real estate	5,077,767.37
Rents	103,633.39
On policy loans	2,288,234.89
On agents' balances	559.70
Discount on claims paid in advance	5.15
	*10,130,857.61

15 SCHEDULE D

The following table sets forth the net natural premium required for an insurance of $1,000 at the ages stated, and the net level premium for an ordinary life policy of $1,000 issued at age 35, and also the reserve on the ordinary life policy.

NOTE.—The "net" premium does not include any provision for expenses or contingencies.

Age	Natural premium	Level premium	Reserve
35	$8.68	$21.08	$12.88
36	8.81	21.08	26.13
37	8.97	21.08	39.76
38	9.12	21.08	53.77
39	9.30	21.08	68.16
40	9.50	21.08	82.94
41	9.71	21.08	98.11
42	9.95	21.08	113.68
43	10.21	21.08	129.65
44	10.51	21.08	146.01
45	10.83	21.08	162.76
55	18.03	21.08	347.00
57	20.70	21.08	386.14
58	22.26	21.08	405.81
65	38.95	21.08	541.94
75	91.62	21.08	713.87
85	228.69	21.08	857.47
95	970.87	21.08	1,000.00

16 SCHEDULE E

CALCULATION OF RESERVE

Retrospective method

The following table sets forth the calculation of the reserve by the retrospective method for an ordinary life policy of $1,000 issued at

* Of this total, only $6,220,570.99 was required for and applied to the addition to the reserve in the year 1917.

age 35 on the basis adopted and used by the plaintiff, viz, the American Experience Table of Mortality and 3% interest:

(1) Age	(2) Reserve (beginning of year)	(3) Interest	(4) Sum of (2) and (3)	(5) Contribution to death losses	(6) Reserve (end of year)
5					
36	$21.08	$0.63	$21.71	$8.83	$12.88
37	33.96	1.02	34.98	8.85	26.13
38	47.21	1.42	48.63	8.87	39.76
39	60.84	1.83	62.67	8.90	53.77
30	74.85	2.25	77.10	8.94	68.16
41	89.24	2.68	91.92	8.98	82.94
42	104.02	3.12	107.14	9.03	98.11
43	119.19	3.58	122.77	9.09	113.68
44	134.76	4.04	138.80	9.15	129.65
45	150.73	4.52	155.25	9.24	146.01
45	167.09	5.01	172.10	9.34	162.76
55	348.66	10.46	359.12	12.12	347.00
65	544.00	16.32	560.32	18.38	541.94
75	719.29	21.58	740.87	27.00	713.87
85	865.09	25.95	891.04	33.57	857.47
	970.87	29.13	1,000.00		1,000.00

Prospective method

The following table sets forth the calculation of the reserve by the prospective method for an ordinary life policy of $1,000 issued at age 35 on the basis adopted and used by the plaintiff, viz, the American Experience Table of Mortality and 3% interest:

Age	Present value of insurance	Present value of future premiums	Difference = reserve (end of year)
35			
36	$427.36	$414.48	$12.88
37	435.04	408.91	26.13
38	442.95	403.19	39.76
39	451.07	397.30	53.77
40	459.42	391.26	68.16
41	468.00	385.06	82.94
42	476.80	378.69	98.11
43	485.83	372.15	113.68
44	495.10	365.45	129.65
45	504.58	358.57	146.01
55	514.30	351.54	162.76
65	621.18	274.18	347.00
75	734.27	192.33	541.94
85	834.01	120.14	713.87
95	917.32	59.85	857.47
	1,000.00	0	1,000.00

17

SCHEDULE F

Yearly net addition to reserve

Year (1)	From premium (2)	From interest (3)	Total (4)	Reserve at end of year (5)
1845 & 1846	$19,645.05	$607.58	$20,252.63	$20,252.63
1847	71,815.73	2,292.27	74,108.00	94,360.63
1848	86,056.34	5,607.71	91,664.05	186,024.68
1849	179,048.56	11,246.90	190,295.46	376,320.14
1850	108,373.49	17,571.71	125,945.20	502,265.34
1851	131,632.76	23,187.01	154,819.77	657,085.11
1852	121,609.29	29,301.62	150,910.91	807,996.02
1853	329,383.20	39,701.54	369,084.74	1,177,080.76
1854	104,858.57	50,184.08	155,042.65	1,332,123.41
1855	101,318.54	56,440.11	157,758.65	1,489,882.06
1856	108,893.15	63,033.82	171,926.97	1,661,809.03
1857	117,450.28	70,225.88	187,676.16	1,849,485.19
1858	104,580.79	77,623.49	182,204.28	2,031,689.47
1859	177,948.54	86,557.70	264,506.24	2,296,195.71
1860	183,614.40	97,469.51	281,083.91	2,577,279.62
1861	−156,634.62	101,998.46	−54,636.16	2,522,643.46
1862	−305,218.87	96,736.08	−208,482.79	2,314,160.67
1863	355,336.64	101,707.31	457,043.95	2,771,204.62
1864	737,333.89	128,158.02	865,491.91	3,636,696.53
1865	1,416,271.85	177,340.10	1,593,611.95	5,230,308.48
1866	1,446,166.05	242,995.57	1,689,161.62	6,919,470.10
1867	1,362,009.78	310,223.47	1,672,233.25	8,591,703.35
1868	2,984,632.93	411,592.65	3,396,225.58	11,987,928.93
1869	2,014,049.44	530,406.27	2,544,455.71	14,532,384.64
1870	1,812,692.88	630,152.29	2,442,845.17	16,975,229.81
1871	1,948,286.71	732,627.48	2,680,914.19	19,656,144.00
1872	1,548,056.42	833,884.58	2,381,941.00	22,038,085.00
1873	1,210,862.84	924,225.16	2,135,088.00	24,173,173.00
1874	830,495.98	1,003,609.02	1,834,105.00	26,007,278.00
1875	682,502.82	1,075,450.18	1,757,953.00	27,765,231.00
1876	121,382.08	1,135,751.92	1,257,134.00	29,022,365.00
1877	−172,433.28	1,181,067.28	1,008,634.00	30,030,999.00
1878	−1,056,373.42	1,204,196.42	147,823.00	30,178,822.00
1879	−823,581.86	1,214,980.86	391,399.00	30,570,221.00
1880	−608,574.24	1,235,344.24	626,770.00	31,196,991.00
1881	−409,361.26	1,264,992.26	855,631.00	32,052,622.00
1882	−438,631.62	1,299,318.62	860,687.00	32,913,309.00
1883	−271,572.08	1,337,858.08	1,066,286.00	33,979,595.00
1884	−310,032.00	1,380,595.00	1,070,563.00	35,050,158.00
1885	−435,422.52	1,421,732.52	986,310.00	36,036,468.00
1886	−322,285.96	1,464,298.96	1,142,013.00	37,178,481.00
1887	−355,375.48	1,510,236.48	1,154,861.00	38,333,342.00
1888	−188,066.12	1,560,788.12	1,372,722.00	39,706,064.00
1889	76,444.04	1,622,215.96	1,698,660.00	41,404,724.00
1890	104,387.92	1,692,119.08	1,796,507.00	43,201,231.00
18 1891	11,530.16	1,763,550.84	1,775,081.00	44,976,312.00
1892	445,448.40	1,844,858.60	2,290,307.00	47,266,619.00
1893	63,878.60	1,930,553.40	1,994,432.00	49,261,051.00
1894	34,403.74	2,011,357.26	2,045,761.00	51,306,812.00
1895	115,339.56	2,096,509.44	2,211,849.00	53,518,661.00
1896	−48,225.38	2,183,119.08	2,134,893.70	55,653,554.70
1897	145,750.50	2,274,602.16	2,420,352.66	58,073,907.36
1898	449,541.14	2,379,543.06	2,829,084.20	60,902,991.56
1899	601,195.90	2,498,090.67	3,099,286.57	64,002,278.13
1900	767,044.54	2,625,958.88	3,393,003.42	67,395,281.55
1901	923,008.54	2,767,398.65	3,690,407.19	71,085,688.74
1902	1,324,210.64	2,923,277.72	4,247,488.36	75,333,177.10
1903	1,429,633.68	3,094,687.20	4,524,320.88	79,857,497.98
1904	2,021,797.58	3,168,163.31	5,189,960.89	85,047,458.87
1905	2,076,269.53	3,350,826.12	5,427,095.65	90,474,554.52
1906	2,788,555.93	3,530,490.89	6,319,046.82	96,793,601.34
1907	2,860,098.81	3,727,343.45	6,587,442.26	103,381,043.60
1908	2,816,797.64	3,926,908.83	6,743,706.47	110,124,750.07
1909	3,111,600.50	4,117,444.38	7,229,044.88	117,353,794.95
1910	3,298,353.86	4,502,336.89	7,800,690.75	125,154,485.70
1911	5,611,672.95	4,697,916.50	10,309,589.45	135,464,075.15
1912	4,018,590.26	4,671,277.28	8,689,867.54	144,153,942.69
1913	4,629,167.97	4,912,910.35	9,542,078.32	153,696,021.01
1914	4,559,438.82	5,175,146.70	9,734,585.52	163,430,606.53
1915	4,834,852.36	5,468,361.11	10,303,213.47	173,733,820.00
1916	6,668,623.24	5,856,352.76	12,524,976.00	186,258,796.00
1917	8,336,560.01	6,220,570.99	14,557,131.00	200,815,927.00

SCHEDULE G

ORIGINAL RETURN

[Form 1030 (Revised January, 1918).—United States Internal Revenue]

INSURANCE COMPANY RETURN

(Including Mutual Life and Mutual Marine)

Return of annual net income for the calendar year 1917.
Name of company, The Mutual Benefit Life Insurance Company.
Principal office, 750 Broad Street, Newark, N. J.
Kind of business carried on, life insurance.

Date of organization, 1845.

1. Total amount of paid-up capital stock outstanding at the close of the year, or if there is no capital stock the capital other than interest-bearing indebtedness employed in the business at the close of the year. Unissued or treasury stock must not be included in this item, but only stock actually issued and outstanding at the close of the year for which this return is made.	(a) Paid-up "common stock"	$ 0
	(b) Paid-up "preferred stock"	0
	Total paid-up stock	$ 0
	or (c) Capital employed in business	$214,808,596.65

2. Total amount of bonded or other interest-bearing indebtedness outstanding at the close of the year, exclusive of indebtedness wholly secured by collateral the subject of sale or hypothecation in the ordinary business of the company and exclusive also of indebtedness incurred in the purchase of securities, the income from which is not subject to income tax.

Character of obligation.	Rate of interest.	Principal.
		$
Total indebtedness		$ 0

INCOME

3. (a) From premiums		831,788,744.28
(b) Income from rentals		103,433.39
(c) Income from interest (see item 3c on back of return)		9,821,630.74
(d) Income from dividends (see item 3d on back of return)		0
(e) Income from all other sources (see item 3e on back)		1,179,556.54
Total gross income		$42,893,564.95
Less total deductions		41,085,225.62
8. Total net income		$1,808,339.33
Less: (a) Excess profits tax (item 12)	$ 0	
(b) Dividends received out of earnings of 1913, 1914, 1915	$ 0	
Total (a plus b)		0
9. (a) Amount taxable at 2% (item 8 less total of a plus b)		$1,808,339.33
(b) Amount taxable at 1% (item 8b)		0
10. Amount of total net income shown in item 8		1,808,339.33
Less: (a) Excess profits tax (item 12)	$ 0	
(b) Dividends received (item 3d)	0	
Total (a plus b)		0
11. Amount taxable at 4% (item 10 less total of a plus b)		$1,808,339.33
If return is made for a full fiscal year ended in 1917, compute tax on as many twelfths of item 11 as there are months from January 1, 1917, to the close of the fiscal year. Enter amount taxable here	$ 0	

DEDUCTIONS

4. Expenses, general	85,066,570.54
5. (a) Losses charged off (other than policy payments)	38,527.30
(b) Depreciation charged off	25,814.58
(c) Payments on policies	20,669,808.48
(d) Net addition to reserve fund	14,357,131.00
(e) Mutual marine premiums repaid with interest	0
6. (a) Interest actually paid, except as entered under 6b	0
(b) Interest paid on indebtedness wholly secured by collateral	0
7. (a) Domestic taxes paid, not including income and excess profits taxes	787,373.72
(b) Foreign taxes paid	0
Total deductions	$41,085,225.62

TAX

12. Amount of excess profits tax (see instructions below)	$	0
13. Amount of 2% tax (2% of item 9a)		36,166.79
14. Amount of 1% tax (1% of item 9b)		0
15. Amount of 4% tax (4% of item 11)		72,333.57
16. Total tax assessable		$108,500.36

Copy of above return as amended by Commissioner of Internal Revenue, changes shown in black type

1. Total amount of paid-up capital stock outstanding at the close of the year, or if there is no capital stock the capital other than interest-bearing indebtedness employed in the business at the close of the year. Unissued or treasury stock must not be included in this item, but only stock actually issued and outstanding at the close of the year for which this return is made.	(a) Paid-up "common stock"	$ 0
	(b) Paid-up "preferred stock"	0
	Total paid-up stock	$ 0
	or (c) Capital employed in business	$214,808,596.65

9. (a) Amount taxable at 2% (item 8 less total of a plus b)		$1,808,339.33
(b) Amount taxable at 1% (item 8b)		0
10. Amount of total net income shown in item 8		1,808,339.33
Less: (a) Excess profits tax (item 12)	$ 0	
(b) Dividends received (item 3d)	0	
Total (a plus b)		0
11. Amount taxable at 4% (item 10 less total of a plus b)		$1,808,339.33
If return is made for a full fiscal year ended in 1917, compute tax on as many twelfths of item 11 as there are months from January 1, 1917, to the close of the fiscal year. Enter amount taxable here		$ 0

Tax

12. Amount of excess profits tax (see instructions below)		$ 0
13. Amount of 2% tax (2% of item 9a)		36,166.79
14. Amount of 1% tax (1% of item 9b)		0
15. Amount of 4% tax (4% of item 11)		72,333.57
16. Total tax assessable		$108,500.36

Copy of above return as amended by Commissioner of Internal Revenue, changes shown in black type

1. Total amount of paid-up capital stock outstanding at the close of the year, or if there is no capital stock the capital other than interest-bearing indebtedness employed in the business at the close of the year. Unissued or treasury stock must not be included in this item, but only stock actually issued and outstanding at the close of the year for which this return is made.

(a) Paid-up "common stock"	$	0
(b) Paid-up "preferred stock"		0
Total paid-up stock	$	0
or (c) Capital employed in business		$214,808,596.65

2. Total amount of bonded or other interest-bearing indebtedness outstanding at the close of the year, exclusive of indebtedness wholly secured by collateral the subject of sale or hypothecation in the ordinary business of the company and exclusive also of indebtedness incurred in the purchase of securities, the income from which is not subject to income tax.

Character of obligation.	Rate of interest.	Principal.
		$
Total indebtedness		$ 0

Income

3. (a) From premiums		$31,788,744.28
(b) Income from rentals		103,633.39
(c) Income from interest (see item 3c on back of return)		9,821,630.74
(d) Income from dividends (see item 3d on back of return)		0
(e) Income from all other sources (see item 3e on back)		1,179,556.54
Total gross income		$42,893,564.95
Less total deductions		**41,111,749.31**
8. Total net income		**$1,781,815.64**
Less: (a) Excess profits tax (item 12)	**$90,820.34**	
(b) Dividends received out of earnings of 1913, 1914, 1915	$ 0	
Total (a plus b)		**90,820.34**
9. (a) Amount taxable at 2% (item 8 less to total of a plus b)		**$1,690,995.30**
(b) Amount taxable at 1% (item 8b)		0
10. Amount of total net income shown in item 8		**$1,781,815.64**
Less: (a) Excess profits tax (item 12)	**$90,820.34**	
(b) Dividends received (item 3d)	0	
Total (a plus b)		**90,820.34**
11. Amount taxable at 4% (item 10 less total of a plus b)		**$1,690,995.30**
If return is made for a full fiscal year ended in 1917, compute tax on as many twelfths of item 11 as there are months from January 1, 1917, to the close of the fiscal year. Enter amount taxable here		0

Deductions

4. Expenses, general	$5,006,570.54
5. (a) Losses charged off (other than policy payments)	38,527.30
(b) Depreciation charged off	**52,338.27**
(c) Payments on policies	20,669,808.48
(d) Net addition to reserve fund	14,557,131.00
(e) Mutual marine premiums repaid with interest	0
6. (a) Interest actually paid, except as entered under 6b	0
(b) Interest paid on indebtedness wholly secured by collateral	0
7. (a) Domestic taxes paid, not including income and excess profits taxes	787,373.72
(b) Foreign taxes paid	0
Total deductions	**$41,111,749.31**

Tax

12. Amount of excess profits tax (see instructions below)	**$90,820.34**
13. Amount of 2% tax (2% of item 9a)	**33,819.91**
14. Amount of 1% tax (1% of item 9b)	0
15. Amount of 4% tax (4% of item 11)	**67,639.81**
16. Total tax assessable	**$192,280.06**

SCHEDULE H

ORIGINAL RETURN

[Form 1103—United States Internal Revenue]

CORPORATION EXCESS PROFITS TAX RETURN

Taxable year ended December 31, 1917

Name, The Mutual Benefit Life Insurance Company.
Business address, 750 Broad Street, Newark, N. J.

Kind of business, Life Insurance. Date established, 1845, Jan. 31.

SCHEDULE I.—NET INCOME FOR TAXABLE YEAR SUBJECT TO EXCESS PROFITS TAX

1.	Net income for taxable year shown in Item 8, Form 1030		$1, 808, 339. 33
2.	Plus interest on obligations of the United States issued since September 24, 1917, held by corporation in excess of $5,000 par value		0
3.	Total		1, 808, 339. 33
4.	Less (a) Dividends received as shown in Item 3d, Form 1030	$ 0	
5.	(b) Interest paid (not in excess of legal limit) on indebtedness incurred for purchase of obligations reported in item 2, above	0	0
6.	Net income subject to excess profits tax		$1, 808, 339. 33

SCHEDULE II.—INVESTED CAPITAL

Item	1911	1912	1913	Taxable year
1. Capital, surplus, and undivided profits at the close of the preceding year as shown by corporation's books before making any adjustments therein (from Schedule A)	$	$	$	$198, 712, 831. 17
2. Adjustments by way of additions (from Schedule B)				
3. Total	$	$	$	$198, 712, 831. 17
4. Adjustments by way of deductions (from Schedule C)				4, 171, 901. 33
5. Invested capital at beginning of year (Item 3 less Item 4)	$	$	$	$194, 540, 929. 84
6. Changes in invested capital during year (from Schedules D and E)				8, 144, 916. 61
7. Invested capital for year	$	$	$	$202, 685, 846. 45
8. Total invested capital for pre-war period				$

SCHEDULE III.—DEDUCTION

1.	Percentage—net income to invested capital for pre-war period (Item 6, Schedule F, divided by Item 8, Schedule II). Carry out result as far as desired, but drop the remainder, if any, without increasing the last figure of the percentage	%
2.	Percentage to be used in computing deduction (see Instruction 5)	7%
3.	Amount of deduction computed at above rate on invested capital for taxable year	$14, 188, 009. 25
4.	Exemption (except for foreign corporations)	3, 000. 00
	Total deduction	$14, 191, 009. 25

SCHEDULE IV.—COMPUTATION OF TAX

Classes of income for computation of tax		Amount of income in each class	Deduction (if in excess of 15 per cent of invested capital, enter only 15 per cent on first line and balance on line or lines below)	Balance subject to tax	Rate	Amount of tax
Over—	But not over—					
1	2	3	4	5	6	7
$0. 00	15% of invested capital	$1, 808, 339. 33	$14, 191, 009. 25	$ 0	20%	$ 0
15% of invested capital	20% of invested capital				25%	
20% of invested capital	25% of invested capital				35%	
25% of invested capital	33% of invested capital				45%	
33% of invested capital					60%	
Total		$	$	$	x x	$

$80,000	15% of invested capital	$1,808,228.23	$14,191,002.25	$ 0	20%	$ 0
15% of invested capital	20% of invested capital				25%	
20% of invested capital	25% of invested capital				35%	
25% of invested capital	33⅓% of invested capital				45%	
33⅓% of invested capital					60%	
Total		$	$	$	x x	$

Copy of above return as amended by Commissioner of Internal Revenue—Changes shown in boldface

SCHEDULE I.—NET INCOME FOR TAXABLE YEAR SUBJECT TO EXCESS PROFITS TAX

1. Net income for taxable year shown in item 8, Form 1030			**$1,781,815.64**
2. Plus interest on obligations of the United States issued since September 24, 1917, held by corporation in excess of $5,000 par value			0
3. Total			**1,781,815.64**
4. Less (a) Dividends received as shown in Item 3d, Form 1030	$	0	
(b) Interest paid (not in excess of legal limit) on indebtedness incurred for purchase of obligations reported in item 2, above		0	0
6. Net income subject to excess profits tax			**$1,781,815.64**

SCHEDULE II.—INVESTED CAPITAL

Item	1911	1912	1913	Taxable year
1. Capital, surplus, and undivided profits at the close of the preceding year as shown by corporation's books before making any adjustments therein (from Schedule A)	**$132,878,349.14**	**$142,139,080.45**	**$151,670,175.75**	**$198,713,925.54**
2. Adjustments by way of additions (from Schedule B)	**2,437,003.25**	**2,449,309.86**	**2,528,401.98**	**2,772,640.96**
3. Total	**$135,315,352.39**	**$144,588,390.31**	**$154,198,577.73**	**$201,486,566.50**
4. Adjustments by way of deductions (from Schedule C)	**125,200,182.11**	**135,600,202.90**	**144,329,346.74**	**186,756,083.06**
5. Invested capital at beginning of year (Item 3 less Item 4)	**$10,115,170.28**	**$8,988,187.41**	**$9,869,230.99**	**$14,730,483.44**
6. Changes in invested capital during year (from Schedules D and E)	**0**	**0**	**0**	**11,439.68**
7. Invested capital for year	**$10,115,170.28**	**$8,988,187.41**	**$9,869,230.99**	**$14,719,043.76**
8. Total invested capital for pre-war period				**$28,972,588.68**

SCHEDULE III.—DEDUCTION

1. Percentage—net income to invested capital for pre-war period (Item 6, Schedule F, divided by Item 8, Schedule II). Carry out result as far as desired, but drop the remainder, if any, without increasing the last figure of the percentage		**9.065%**
2. Percentage to be used in computing deduction (see Instruction 5)		**9 %**
3. Amount of deduction computed at above rate on invested capital for taxable year		**$1,324,713.94**
4. Exemption (except for foreign corporations)		3,000.00
Total deduction		**$1,327,713.94**

SCHEDULE IV.—COMPUTATION OF TAX

Classes of income for computation of tax		Amount of income in each class	Deduction (if in excess of 15 per cent of invested capital, enter only 15 per cent on first line and balance on line or lines below)	Balance subject to tax	Rate	Amount of tax
Over—	But not over—					
1	2	3	4	5	6	7
$0.00	**15% of invested capital**	**$1,781,815.64**	**$1,327,713.94**	**$454,101.70**	**20%**	**$90,820.34**
15% of invested capital	20% of invested capital				25%	
20% of invested capital	25% of invested capital				35%	
25% of invested capital	33⅓% of invested capital				45%	
33⅓% of invested capital					60%	
Total		$	$	$	x x	$

Totals of columns (2), (3), and (4) at end of respective years indicated

1845–1908	33, 569, 857. 14	76, 554, 892. 93	110, 124, 750. 07
1845–1910	39, 979, 811. 50	85, 174, 674. 20	125, 154, 485. 70
1845–1911	45, 591, 484. 45	89, 872, 590. 70	135, 464, 075. 15
1845–1912	49, 610, 074. 71	94, 543, 867. 98	144, 153, 942. 69
1845–1916	70, 302, 157. 10	115, 956, 638. 90	186, 258, 796. 00
1845–1917	78, 638, 717. 11	122, 177, 209. 89	200, 815, 927. 00

21 SCHEDULE I

In the adjustment of plaintiff's net income for 1917 the Commissioner of Internal Revenue increased the deduction on account of depreciation from $25,814.58 to $52,338.27, or by $26,523.69. This reduced plaintiff's net income from $1,808,339.33 to $1,781,815.64, as set forth in item 1 of paragraph 12 of the amended complaint.

The various adjustments made by the Commissioner in the plaintiff's war excess profits tax return, referred to in item 2 (a) of paragraph 12 of the amended complaint, which reduced plaintiff's invested capital for the taxable year by the sum of $1,708,006.69, were as follows:

The company claimed in its original return that its invested capital had increased during the year 1917 by $8,144,916.61 on account of premiums paid by policyholders during 1917 averaged monthly according to plaintiff's understanding of section 207 of the act of October 3, 1917. The Commissioner disallowed this item as invested capital for the year 1917 on the ground that it represented current earnings for the year 1917 which are excluded as invested capital for the year under the statutory definition. Plaintiff's invested capital was thereby reduced by		$8, 144, 916. 61
The Commissioner deducted on account of—		
Depreciation		496, 192. 69
Income taxes withheld at source		1, 094. 37
Pro rata of income tax paid in 1917		11, 439. 68
Making total deductions of		8, 653, 643. 35
The Commissioner increased the capital, surplus and undivided profits at the beginning of the taxable year, as shown by plaintiff's books, by the amount of income taxes withheld at source	$1, 094. 37	
The Commissioner allowed as part of the invested capital the difference between the cost value and the book value of the company's assets, such difference being	2, 772, 640. 96	
The Commissioner did not deduct the amount of State and municipal bonds held at the close of the taxable year on the ground that they were represented in other assets which he deducted. The company's holdings of such bonds were	4. 171, 901. 33	
Making total deductions of	6, 945, 636. 66	6, 945, 636. 66
Leaving a net deduction from plaintiff's invested capital, exclusive of the policy reserve of		1, 708, 006. 69

22 The Commissioner computed plaintiff's invested capital for the pre-war years set forth in item 3 of paragraph 12 of the amended complaint) as follows:

For the pre-war year 1911

The capital, surplus, and undivided profits at the close of the preceding year, as shown by plaintiff's books before making any adjustments therein, were determined by the Commissioner as shown by the annual report of the company to the commissioner of banking and insurance for the State of New Jersey at		$132,878,349.14
The Commissioner added thereto the difference between the cost value and the book value of the company's assets, such difference being		2,437,003.25
Making a total of		135,315,352.39
The Commissioner deducted:		
On account of depreciation	$201,243.41	
On account of policy reserve	124,998,938.70	
Making deductions of	125,200,182.11	125,200,182.11
And leaving invested capital for the pre-war year 1911 at		$10,115,170.28

(23) **For the pre-war year 1912**

The capital, surplus, and undivided profits at the close of the preceding year, as shown by plaintiff's books before making any adjustments therein were determined by the commissioner, as shown by the annual report of the company to the commissioner of banking and insurance for the State of New Jersey, at		$142,139,080.45
The commissioner added thereto the difference between the cost value and the book value of the company's assets, such difference being		2,449,309.86
Making a total of		144,588,390.31
The commissioner deducted:		
On account of depreciation	$246,503.23	
On account of agents' overremittances	15,488.52	
On account of policy reserve	135,338,211.15	
Making total deductions of	135,600,202.90	135,600,202.90
And leaving invested capital for the pre-war year 1912 at		8,988,187.41

(24) **For the pre-war year 1913**

The capital, surplus, and undivided profits at the close of the preceding year, as shown by plaintiff's books before making any adjustments therein, were determined by the commissioner, as shown by the annual report of the company to the commissioner of banking and insurance, for the State of New Jersey, at		151,670,175.75
The commissioner added thereto the difference between the cost value and the book value of the company's assets, such difference being		2,528,401.98
Making a total of		154,198,577.73
The commissioner deducted:		
On account of depreciation	$291,763.05	
On account of policy reserve	144,037,583.69	
Making total deductions of	144,329,346.74	144,329,346.74
And leaving invested capital for the pre-war year 1913 at		9,869,230.99

SCHEDULE J

Comparative statement of income and deductions and net income shown on income tax returns as filed by the Mutual Benefit Life Insurance Company, and as adjusted by Internal Revenue Department

Income	1911	1912	1913	1914	1915	1916	1917	1918	Statements for 1917 and 1918 made on same basis as those of previous years	
									1917	1918
Premiums	$17,983,604.80	$19,412,463.38	$19,409,536.03	$20,468,925.87	$21,647,056.97	$23,002,253.35	$31,788,744.28	$34,380,939.09	$25,736,491.04	$28,088,413.50
Rentals	97,749.44	91,582.98	99,386.92	113,065.85	110,184.68	108,043.52	103,633.39	110,865.64	103,633.39	110,865.64
Interest	6,266,326.36	7,000,733.32	7,544,959.30	7,944,227.50	8,545,911.16	9,177,468.12	9,821,630.74	10,506,314.63	9,821,630.74	10,506,314.63
All other sources	144,693.07	49,214.16	48,104.66	146,044.96	21,860.00	26,142.95	1,179,556.54	1,165,128.70	28,142.50	0
Total gross income	24,492,373.67	26,553,993.84	27,101,986.91	28,672,264.18	30,318,012.13	32,313,907.88	42,893,564.95	46,163,248.06	35,689,897.67	38,705,593.77
Gross income as adjusted by Internal Revenue Department			27,083,962.18	28,586,446.29	30,293,562.04					
Deductions										
Expenses, general	3,263,592.82	3,442,115.23	3,511,118.24	3,523,490.94	3,670,745.19	4,127,136.67	5,006,570.54	4,837,346.89	5,006,570.54	4,837,346.89
Rentals				85,303.08	89,584.01	87,531.44				
Losses—other than policy payments	25,099.92	13,701.53	2,500.00	13,889.19	30,271.80	23,150.34	38,527.30	110,055.10	38,527.30	110,055.10
Depreciation	246,810.78	170,656.25	165,442.39	143,732.08	279,721.72	53,214.56	25,814.58	60,900.05	25,814.58	60,900.05
Payments on policies	10,890,348.85	12,407,980.86	11,886,884.57	13,064,471.12	13,469,219.93	13,845,815.71	20,669,808.48	24,785,566.36	13,466,141.26	17,327,912.07
Net addition to reserve fund	10,309,589.45	8,689,867.54	9,542,078.32	9,734,585.52	10,303,213.47	12,524,976.00	14,557,131.00	15,506,616.00	14,557,131.00	15,506,616.00
Domestic taxes (not including income and excess profits taxes for 1917–1918	538,380.24	587,441.73	569,855.56	567,624.37	620,522.95	702,690.68	787,373.72	810,401.70	787,373.72	810,401.70
Tax exempt interest			203,858.56							
Total deductions	25,273,822.06	25,311,763.14	25,881,737.64	27,133,096.30	28,463,279.37	31,364,515.35	41,085,225.62	46,110,886.10	33,881,558.34	38,653,231.81
Total gross income	24,492,373.67	26,553,993.84	27,101,986.91	28,672,264.18	30,318,012.13	32,313,907.88	42,893,564.95	46,163,248.06	35,689,897.67	38,705,593.77
Total deductions	25,273,822.06	25,311,763.14	25,881,737.64	27,133,096.30	28,463,279.37	31,364,515.35	41,085,225.62	46,110,886.10	33,881,558.34	38,653,231.81
Total net income	0	1,242,230.70	1,220,249.27	1,539,167.88	1,854,732.76	949,392.53	1,808,339.33	52,361.96	1,808,339.33	52,361.96
Net income as adjusted by Internal Revenue Department		1,304,084.68	1,304,950.72	1,538,914.92	1,929,985.21	376,792.51	1,781,815.64		1,781,815.64	

NOTE.—The returns for 1917 and 1918 were on a different basis from those of previous years, as plaintiff was required by the Government in 1917 and 1918 to include in both gross income and deductions certain self-balancing bookkeeping items, amounting in 1917 to $7,293,667.28 and in 1918 to $7,457,654.28. This new rule did not affect the taxable income, as the same items appeared on both sides of the account. The last two columns show what the statements for 1917 and 1918 would have been if compiled on the same basis as the previous years, and that the net income was the same on both bases.

26 *Exhibit No. 1 to amended complaint*

Charter and by-laws of The Mutual Benefit Life Insurance Company of Newark, N. J., State of New Jersey

An act to incorporate "The Mutual Benefit Life Insurance Company."

SECTION 1. Be it enacted by the Senate and General Assembly of the State of New Jersey, as follows:

That Thomas V. Johnson, William M. Simpson, Jesse Baldwin, James L. Dickerson, Henry McFarland, Thomas B. Segur, Charles S. Macknet, Guy M. Hinchman, Samuel Meeker, Robert L. Patterson, Marcus L. Ward, Lewis C. Grover, and others, their associates, successors and assigns, shall be, and are hereby ordained, constituted and declared to be a body politic and corporate in fact and in name by the name of "The Mutual Benefit Life Insurance Company," to be located at Newark in this State; and by that name they and their successors shall and may have succession during the continuance of this act, and shall be capable of suing and being sued, pleading and being impleaded, answering and being answered unto, defending and being defended, in all manner of actions, suits, complaints, matters and causes whatever; and that they and their successors may have a common seal, and may alter and change the same at pleasure; and, also, that they and their successors, by the name of "The Mutual Benefit Life Insurance Company," shall be in law capable of purchasing, holding, and conveying any estate, real or personal, for the use of the said corporation: Provided, The lands, tenements and hereditaments, which it shall be lawful for the said corporation to hold, be only such as shall be requisite for the purpose of erect-
27 ing buildings thereon, in which to meet and transact the business of the corporation, or such as shall have been bona fide mortgaged to it by way of security, or conveyed to it in satisfaction of debts, previously contracted in the course of its business, or purchased at sales on judgments or decrees, which shall have been obtained for such debts; and with regard to all such lands, tenements, and hereditaments, so to be held by the said corporation as aforesaid, except such as may be for its immediate accommodation as aforesaid, or such as it may hold by way of mortgage, and whereof the actual possession shall be and remain in the mortgagors, their heirs and assigns, the corporation shall be bound to sell and dispose of, respectively, within five years after it shall acquire the same, and shall not be capable of holding the same after the expiration of five years.

SEC. 2. And be it enacted, That all persons who shall at any time hereafter insure in or with the said association, shall, while they continue so insured, be deemed and taken as members of the said corporation; and that the property and concerns of the said corporation shall be conducted and managed by twelve directors, a majority of whom shall be citizens and residents of this State, and none of

whom shall hold the like office or agency in any other insurance company in this State, to be chosen, by ballot, by and from among the members, and shall hold their office for one year and until others are chosen; and the said directors and officers may always be re-elected, but one one-fourth part or number of the directors must be reelected every year, for which purpose, at their first meeting, they must divide themselves in four sets or classes, of three each; they term of the first class shall expire at the end of one year, the term of the second class shall expire at the end of two years, the term of the third class shall expire at the end of three years, the term of the fourth class shall expire at the end of four years, and so on
28 successively; the seats of these classes shall be supplied by the members of this corporation; and that the election for directors shall be held on the third Monday of January, in every year, at the office of the company, or such other place as a majority of the directors may previously designate, public notice of which shall be given by the secretary, in one or more newspapers printed or circulating in the county of Essex, at least two weeks previous to the time of holding such election; and if any of the said directors shall die, refuse to serve, or neglect to act in their said office for the space of two months, then and in every such case the remaining directors shall have power to fill such vacancy or vacancies until the next annual election; and in case it should happen that an election for directors should not be held on the day when pursuant to this act it ought to be held, the said corporation shall not be dissolved for that cause, but it shall and may be lawful to hold an election for directors pursuant to law; and until an election for directors shall be held according to the provisions of this act, the persons named in the first section of this act shall have the direction and management of the said corporation.

SEC. 3. And be it enacted, That it shall and may be lawful for the said corporation to insure their respective lives, and to make all and every insurance appertaining to or connected with life risks of whatever kind or nature, as well of the sound in health, as the infirm or invalid.

SEC. 4. And be it enacted, That it shall be lawful for any married woman, by herself and in her name, or in the name of any third person, with his assent, as her trustee, to cause to be insured for her sole use, the life of her husband for any definite period or for the term of his natural life; and in case of her surviving her husband the sum or net amount of the insurance becoming due and payable by
29 the terms of the insurance, shall be payable to her, to and for her own use free from the claims of the representatives of her husband, or of any of his creditors; but such exemption shall not apply when the amount of premium annually paid shall exceed three hundred dollars.

SEC. 5. And be it enacted, That in case of the death of the wife, before the decease of the husband, the amount of the insurance may

be made payable after death to her children for their use, and to their guardian, if under age.

SEC. 6. And be it enacted, That it shall and may be lawful for the officers of said corporation to take the notes or obligations of the members for the amount, either in part or the whole of the premium of insurance, in proportion to the amount insured.

SEC. 7. And be it enacted, That the directors for the time being, or a majority of them, shall have power to make and prescribe such by-laws, rules, and regulations, as to them shall appear needful and proper, for the management and disposition of the stock, property, estate and effects of the said corporation, and for all such matters as appertain to the business thereof; and shall have power to appoint an actuary, from among themselves, and such other additional officers, clerks, and servants, for carrying on the business of said corporation, as they may select, with such allowances as to them shall appear just and satisfactory: Provided, That such by-laws, rules, and regulations, shall not be repugnant to the Constitution or laws of the United States or of this State.

SEC. 8. And be it enacted, That at the first meeting of the directors held after the organization of this company, and at every annual meeting of the members in each year after, the directors shall choose, from among themselves one person for president, who shall continue in office until the next annual meeting, and until another shall be appointed in his place.

SEC. 9. And be it enacted, That all policies of insurance which shall be made by the said corporation, in pursuance of this act, shall be made on such terms and conditions, and for such periods of time, and confined to such persons, as shall be from time to time ordered and prescribed by the by-laws, rules and regulations of said corporation: and, if at any time it shall so happen that there shall be just claims on the corporation for losses sustained, to a greater amount than they have funds on hand to discharge, in such cases the directors for the time being shall with all convenient expedition proceed to assess such deficiency, in a ratable proportion, on the members of the association, or their lawful representatives, according to the amount of each member's insurance: Provided, That such assessment shall not exceed the amount of the note or obligation given by each member: which rates or assessment shall be approved of by a majority of the directors, and notice in writing shall be given to each member, or his lawful representative, of the assessment and amount by him, her, or them, required to be paid; and each and every member, or his lawful representative, so notified, shall pay the same to the treasurer for the time being within sixty days after such notification and in default thereof shall forfeit all right and claim to any policy that he may have obtained, and be no longer a member of the association: and shall also be liable for the amount of such assessment, with interest, to be recovered by action of debt, with costs of suit, before any court of competent jurisdiction.

SEC. 10. And be it enacted, That three or more of the directors shall have power to call a meeting of the directors, by giving
31 notice in one or more newspapers published or circulating in the County of Essex, at least ten days before said meeting.

SEC. 11. And be it enacted, That no part of the funds of said corporation shall be used for banking purposes.

SEC. 12. And be it enacted, That it shall be lawful for the legislature at any time hereafter, to alter, amend, modify, or repeal this act, and that this act shall continue in operation twenty years and no longer. Approved January 31st, 1845.

CHARLES C. STRATTON.

32 STATE OF NEW JERSEY.

A supplement to the act, entitled, "An act to incorporate the Mutual Benefit Life Insurance Company," passed January thirtieth, eighteen hundred and forty-five.

1. Be it enacted, by the Senate and General Assembly of the State of New Jersey, That the twelfth section of the act, to which this is a supplement, be and the same is hereby repealed.

2. Be it enacted, That it shall be lawful for the legislature, at any time hereafter, to alter, amend, modify, or repeal the act to which this is a supplement.

3. And be it enacted, That this act shall take effect immediately. Approved January 27, 1848.

DANL. HAINES,
Gov.

33 I, S. D. Dickinson, secretary of state of the State of New Jersey, do hereby certify, that the foregoing is a true copy of an act passed by the legislature of said State, and approved by the governor, January 31, 1845, and of a supplement thereto approved January 27, 1848, as taken from and compared with the
[SEAL] originals on file in my office. In testimony whereof, I have hereunto set my hand and affixed my seal of office, at Trenton, this twenty-third day of May, A. D. 1905.

S. D. DICKINSON,
Secretary of State.

34

By-laws

(Revised September, 1916)

Annual election and meeting

SECTION 1. The annual meeting of the company for the election of directors and the transaction of business shall be held at the office of the company, in Newark, N. J., on the third Monday of January, in every year, of which public notice shall be given by the secretary, for two weeks, by advertising in a newspaper published in Newark.

SEC. 2. Two members of the company shall be appointed by the board of directors as inspectors whose duty it shall be honestly and

fairly to conduct such election; and who shall furnish a certificate over their signatures of the result, to be filed and recorded by the secretary of the company. The poll shall be opened at 11 o'clock a. m., and be closed at 1 o'clock p. m.

SEC. 3. At the annual election for directors, each member of the company shall be entitled to one vote when the insurance is for a sum not exceeding $2,000; over $2,000 and up to $5,000, to two votes; over $5,000, to three votes.

Election and appointment of officers

SEC. 4. The first meeting of the directors after the annual meeting of the company shall be held at one o'clock p. m., on the day of such annual meeting, when they shall elect a president from among themselves by ballot. They may also elect two vice presidents, a treasurer, secretary, and such other officers as may have been designated by the board, who shall continue in office until the next annual meeting or until others are appointed in their places, and who shall be subject to removal at the pleasure of a majority of the board of directors.

35 Meetings

SEC. 5. The directors shall hold regular meetings on Wednesday of each week. Special meetings may be called by the president, or in his absence by a vice president, two days' written notice being given to each member of the board. Three members of the board may call a special meeting, by giving two days' written notice of such meeting to each member of the board. Five directors shall constitute a quorum for the transaction of business, but a less number may adjourn from time to time.

SEC. 6. In the meetings of the board the order of business shall be:

1. Reading of minutes of last meeting;
2. Reports of special committees;
3. Unfinished business;
4. Miscellaneous business;

unless otherwise ordered by the board.

Checks

SEC. 7. No check shall be drawn, except for salaries and current expenses, or in pursuance of a contract, without the authority of the board. All checks shall be drawn to the order of the party to whom the payment is due, and be signed by the president, the vice presidents, the treasurer, and the comptroller, or any two of them. The assistant treasurer may sign in place of the treasurer.

Duties of the president

SEC. 8. The president, acting under the advice and direction of the board, shall have the general superintendence of the business

of the company. He shall preside at all meetings of the board. He shall sign all such papers, contracts and agreements as shall be authorized by the board. He shall have exclusive charge
36 of the corporate seal of the company, and shall have power to affix the same to all contracts, to certificates acknowledging satisfaction of mortgages, to releases of mortgaged premises when authorized by the board, to powers of attorney for the transfer of stocks, bonds, etc., to pleadings in actions at law, and to the appointments of attorneys for other States when required by the laws thereof. All reports required from the other officers shall be made to him. He shall, at meetings of the board, lay before it all information connected with the interests and business of the company, and, from time to time, make such suggestions and recommendations as he may deem necessary. An annual report shall be prepared and presented by him to the directors.

Duties of vice presidents

SEC. 9. It shall be the duty of the vice presidents to assist the president in all duties that he may assign to them, and in case of the disability or absence of the president to perform the duties required of the president. They shall also perform such other duties as may from time to time be assigned them by the board. They may in the absence of the secretary, treasurer or comptroller, sign in their place.

Duties of the secretary

SEC. 10. The secretary shall countersign all policies and other documents requiring his signature, and shall make such attestations of the correctness of the company's records as may be required. He shall receive all communications to the company, and conduct the general correspondence. His duties may be changed from time to time by resolution of the board or direction of the president. In his absence his duties shall be performed by a vice president or an assistant secretary.

Duties of the treasurer

SEC. 11. The treasurer shall have charge of all moneys, cer-
37 tificates of stock, bonds, premium notes, bonds and mortgages, and other evidences of debt belonging to the company. He shall deposit the cash funds of the company in such bank or banks as the board shall direct, to the credit of the company. He shall collect all coupons, the interest on bonds, on bonds and mortgages, and also on investments of every character held by the company. No moneys shall be paid by him except for salaries and current expenses, or in pursuance of a contract, without the authority of the board. He shall make no advances on account of mortgage loan, unless satisfied that they will be secured by first

liens on real estate, the title to which has been approved by the counsel or associate counsel of the company. He shall keep a cash book which shall show all cash transactions, and other books in which shall be properly recorded the assets of the company which are in his custody; and he shall perform such other duties as shall be required of him by the board or by the president.

Mathematician and actuary

Sec. 12. The board shall annually appoint a mathematician whose duty it shall be to make all necessary computations relating to premium rates, dividends, reserves and surrender values, upon principles recognized and approved by the board. He shall from time to time make a full analysis of the company's mortuary experience, and shall present the results in such a form as may seem best adapted to throw light upon the death rate amongst insured lives. He shall, at the close of each year, prepare a report to the board, showing in detail the company's assets, liabilities and surplus, and shall preserve such a uniform record as shall truly exhibit the growth and condition of the company from year to year. He shall collect useful data, books, documents, tables and official records relating to the business of life insurance, and perform such other duties as may be imposed upon him by the board or by the President.

38 There shall also be an actuary chosen by the board, who shall assist the mathematician in the conduct of the mathematical department.

Superintendent of agencies

Sec. 13. There shall be chosen annually a superintendent of agencies, who shall be charged with the supervision of the company's insurance agents to the end that they may efficiently and faithfully perform their duties. He shall, by correspondence and personal interviews, give them such information, encouragement and advice as he shall be able and think expedient for their work and the promotion of the company's interest, and he shall perform such other duties as may be required by the board or by the president.

Comptroller

Sec. 14. There shall be a comptroller of the company, who shall be appointed by and hold office during the pleasure of the board. It shall be his duty to see that all cash paid and all checks drawn against the company shall be correct and in accordance with the claims against the company, and he shall perform such other duties as may be imposed upon him by the board or by the president.

Auditor

Sec. 15. The board shall annually appoint an auditor whose duty it shall be to cause monthly and quarterly statements of the com-

pany's receipts and disbursements and also its assets to be prepared, and to report the same duly certified to the directors. And he shall each month examine the company's cash book and agency reports and shall see that there are proper vouchers for all expenditures charged therein, and shall report thereon to the president and to the finance committee; and he shall perform such other duties as may be assigned him by the board or by the president.

39

Counsel of the company

SEC. 16. It shall be the duty of the counsel of the company to afford and communicate to the officers and directors, in writing or otherwise, whenever needed, such counsel, legal advice, and information as may be requisite to guide them respectively in a safe and correct discharge of their duties. He shall have general charge of all suits brought by or against the company. And he shall guard the company, by his advice and counsel, against the allowance of any illegal or unjust claims against it; and shall perform such other duties as shall be required of him by the board or by the president.

Associate counsel of the company

SEC. 17. The associate counsel shall examine and decide on the validity of all titles to real estate offered as security for loans made by, or for the forbearance of money due to the company; and if title be approved shall report the results of his examination and his decisions to the treasurer such reports to be accompanied by full and satisfactory abstracts of title, and also by notes, bonds and mortgages, or trust deeds, in proper legal form, and duly executed with such collateral security as may be required; and all mortgages and trust deeds shall be shown by the abstracts to be first liens and incumbrances of record upon the property pledged as security for loans. Whenever required, he shall examine the records for unpaid taxes and assessments on property mortgaged to the company. He shall attend to the foreclosure of all mortgages ordered to be foreclosed, and to the collection of all moneys in connection therewith. He shall examine and report as to the sufficiency of the searches and the correctness of the title in each case of release of part of the security covered by any mortgage held by the company, when such release has been approved by the board. He shall attend to
40 the drawing of indemnity bonds, examining and advising as to assignments of policies and policy claims, supplementary policy agreements, change of beneficiaries, and any legal matters regarding loans and surrender values. He shall take such charge of all suits brought by or against the company as the counsel of the company shall from time to time direct, and shall perform such other duties as shall be required of him by the counsel or by the company.

Agents

SEC. 18. Agents shall be appointed and removed by the president, who shall make such reasonable contracts for their services as he may deem advisable. Agents shall comply with the rules and regulations of the company. In every case where an agent shall fail to so comply, the president shall take immediate action thereon, and withdraw such agency unless good cause is shown to the contrary.

Medical board

SEC. 19. There shall be appointed annually by the directors a medical board, to consist of two or more members, to whom applications for insurance shall be submitted for their examination and advice. They shall adopt under the direction of the president, as far as possible, written rules for their government in advising upon the applications that may be submitted to them. They shall keep such record of their proceedings and business as shall be available for reference or information on the part of officers and directors. They shall nominate and remove examiners, subject to the approval of the president. They shall make a mortuary report at the end of each year, of the losses of the company, classifying the diseases of which the insured died. They shall inform themselves, as far as practicable, of all matters pertaining to vital statistics in this and other countries; and shall recommend, whenever they may
41 deem it necessary, such changes in reference to medical examinations or any other matter connected with their department, as may be suggested by their combined experience and information. No policy shall be written on an application not advised by the medical board without the joint concurrence of at least three of the officers of the company. A member of the medical board shall pass upon all losses so far as the medical proofs are concerned, and, when not satisfactory, state in writing what is required.

Finance committee

SEC. 20. A finance committee consisting of the president and four or more other directors shall be chosen by the board of directors annually, and this committee shall have such meetings as may be necessary. They shall consider the finances of the company and examine and report to the board of directors for its approval such investments as they may consider worthy of the consideration of the board. The finance committee shall examine the auditor's monthly reports, and perform such other duties as the board of directors may from time to time by resolution assign to it. The finance committee shall in addition to its regular meetings meet at any time on the call of the president, when he desires to consult with it upon any question relating to the business of the company.

Miscellaneous

SEC. 21. During the months of January and July, in each and every year, the assets of the company shall be examined by a special committee, whose report shall be placed on the minutes.

SEC. 22. The annual statement of the business and affairs of the company shall be prepared by the officers and presented by the president to the directors at their meeting in January.

42 SEC. 23. No officer or director shall receive any compensation for procuring any loan from the company; nor shall any director vote on any loan in which he is personally interested.

SEC. 24. No risk shall be taken on a single life for more than $100,000 at ages 55 and under; $90,000 at age 56; $80,000 at age 57; $70,000 at age 58; $60,000 at age 59; and $50,000 at ages 60 and over. If the applicant be a woman, the amount shall not exceed $5,000; but the officers in their discretion may specially authorize writing insurance up to $25,000 on the life of a woman. Any larger amount on the life of a woman shall require a special authorization by the board.

SEC. 25. The surplus of the company may be distributed from time to time as the board may direct.

SEC. 26. Claims for insurance shall only be paid after satisfactory proof shall have been presented, examined and approved, of the maturing of the contract of insurance by the death of the insured, or by the expiration of the endowment period, and after due observance of the contract by the insured. Such claims shall then be reported to the board.

Alteration of by-laws

SEC. 27. These by-laws may be altered or amended at any meeting by a vote of three-fourths of the directors, and not otherwise, unless thirty days' notice shall have been given to the board in writing, with a distinct statement of what is proposed; and in such cases it shall be the duty of the secretary to give written notice of the proposed alteration, to each member of the board, at least five days previous to the meeting at which it is to be acted upon; and no alteration shall be made unless approved by seven or more members of the board, to be ascertained by yeas and nays.

43 In United States District Court

District of New Jersey

[Title omitted.]

Motion to strike out complaint

Filed November 22, 1920

The defendant, Charles V. Duffy, collector, appearing herein by Elmer H. Geran, United States attorney for the district of New

Jersey, moves to strike out the complaint of the plaintiff because the same is not sufficient in law for the following reason:

That the policy reserve maintained by an insurance company is not a part of its invested capital for the purpose of computing its excess-profits tax.

ELMER H. GERAN,
United States Attorney.

44 In United States District Court

District of New Jersey

[Title omitted.]

Opinion

RELLSTAB, District Judge:

The plaintiff, a New Jersey corporation, sues to recover from the defendant, collector of internal revenue for the fifth district of New Jersey, $83,779.70, war excess-profits tax, imposed upon it for the year 1917, which it paid under protest. It has complied with the necessary prerequisites for the instituting of the present suit.

45 The tax was imposed under the revenue act of October 3, 1917. The defendant moves to strike the complaint. It has been so framed (several times amended) as to present all the facts necessary to a final determination, and by stipulation the decision on this motion is to be a final disposition of the controversy in this court.

The plaintiff is a mutual company, having no capital stock or stockholders, and never carried on any business other than that of mutual life insurance. The plaintiff's policyholders are its members, and they elect from among themselves the directors who manage its business. This business is conducted upon the "level premium plan," under which the maximum annual contribution paid by the policyholder in premiums is uniform throughout the life of the policy. In determining the "level premium" there is added to the mathematical computation of the cost of insurance an amount to provide for salaries, taxes, and other expenses of conducting the business and to take care of unforeseen contingencies, which addition is called "loading."

The plaintiff's assets consist solely of these premiums, the investment thereof, and the income derived from these investments. Inasmuch as the stipulated uniform premiums are in excess of the cost of insurance during the earlier years of the policy and not sufficient to pay the cost of the insurance during its later years, a portion of this excess is by law required to be set aside and held as a reserve or guarantee fund (called the legal reserve) to maintain the insurance during the later years. At the end of each year the excess of income over disbursements is ascertained, and after supplying so much thereof as is required for the increase of its legal reserve

and an additional sum to care for unanticipated losses, expenses, and shrinkage of earnings—an additional safeguard of the stability and continuity of the legal reserve—the balance is returned to the policyholders as a dividends or credit upon their net annual premiums.

46 A detailed statement of this method of conducting mutual life insurance on the "level premium plan" and the nature and application of the excess payments of premiums is set out in Mutual Benefit Life Insur. Co. (the plaintiff herein) *v.* Herold (N. J.), 198 F. 199, 202–4, and Connecticut General Life Ins. Co. *v.* Eaton (Conn.), 218 F. 188.

The laws of the States in which the plaintiff carries on its business require that its assets shall not be less than this legal reserve. The amount of the latter as fixed by the commissioner of banking and insurance of the State of New Jersey on January 1, 1917, was $186,258,796. In the plaintiff's management of its assets there is no segregation or special allocation of any part thereof and the legal reserve is not separately held or invested.

Under the provisions of Title I of the revenue act of September 8, 1916, as amended by Title I of the act of October 3, 1917, the plaintiff filed an income tax return for the year 1917 showing a net income of $1,808,339.33 and paid a tax of $108,500.36. In this return was included all the interest obtained from its securities and investments not specifically exempt from tax. Under the provisions of Title II of the last-mentioned act the plaintiff also filed an excess-profits tax return for the year 1917, showing on its basis of computation that no such tax was due. In this return it declared its invested capital to be $202,685,846.45, which included its legal reserve of $186,258,796. Thereafter, on June 10, 1920, the Commissioner of Internal Revenue (hereinafter referred to as the commissioner) amended the excess-profits tax return, deducting this reserve from the invested capital, allowing only $14,719,043.76 as such capital, and imposing the excess-profits tax sought to be recovered in this suit. This deduction, or nonallowance, is the basis of the plaintiff's suit.

47 The Government contends that the legal reserve of a mutual insurance company can not be its invested capital, because it does not belong to it, but to the policyholders; that such fund is in the nature of a trust fund, and is in fact a liability and not an asset. For some purposes this reserve is a liability or a trust fund, but so is the capital subscribed by shareholders in a stock corporation. Both are treated as a liability in balancing assets and liabilities. In the case of an insolvent stock corporation, its assets are charged with a trust in favor of creditors. On the dissolution or liquidation of a stock corporation, the capital remaining after the payment of debts belongs to the shareholders. So on the dissolution of a mutual insurance company, the holders of unmatured policies, after the payment of matured policies, share pro rata the

assets of the company, including the legal reserve. Mayer *v.* Attorney General, 32 N. J. E. 815, 822. If the legal reserve of a mutual life insurance company is a liability or trust fund in favor of the policyholders, as the Government contends, so are the other assets of the company. The difference between them is merely that the former is required by law to be maintained intact as a guarantee for the payment of such policies, and can not lawfully be diverted to other uses. Under certain tax laws the legal reserves of insurance companies are treated as liabilities. Whether they are to be so considered depends upon the particular kind of tax imposed and the legislative policy adopted in regard thereto.

In the instant case the character of the plaintiff's assets is involved, and the specific question is whether its reserve, or at least $25,500,000 thereof, is invested capital within the meaning of Title II—"War excess profits tax" of the revenue act of October 3, 1917.

The pertinent parts of this title follow:

"Sec. 200. That when used in this title—

48 "The term 'corporation' includes joint stock companies or associations and insurance companies.

* * * * * * *

"The term 'pre-war period' means the calendar years nineteen hundred and eleven, nineteen hundred and twelve, and nineteen hundred and thirteen * * *."

"Sec. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

"Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year."

"Sec. 203. That for the purposes of this title the deduction shall be as follows, except as otherwise in this title provided—

"(a) In the case of a domestic corporation, the sum of (1) an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the pre-war period was of the invested capital for the pre-war period (but not less than seven or more than nine per centum of the invested capital for the taxable year), and (2) $3,000, * * *."

"Sec. 206. That for the purposes of this title the net income of a corporation shall be ascertained and returned * * * (c) for the taxable year upon the same basis and in the same manner as

49 provided in Title I of the act entitled 'An act to increase the revenue, and for other purposes,' approved September eighth, nineteen hundred and sixteen, as amended by this act. * * *"

"Sec. 207. That as used in this title, the term 'invested capital' for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.

"As used in this title, 'invested capital' does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title nor money or other property borrowed, and means, subject to the above limitations:

"(a) In the case of a corporation or partnership: (1) Actual cash paid in; (2) the actual cash value of tangible property paid in, other than cash, for stock or shares in such corporation or partnership at the time of such payment; * * * and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits, earned during the taxable year; * * *."

The pertinent parts of the act of 1916 referred to follow:

"TITLE I—INCOME TAX

"Part II—On corporations

"Sec. 10. That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation, joint-stock company or association, or insurance company, organized in the United States, no matter how created or organized, but not including partnerships, a tax of two per centum upon such income; * * *.

"Deductions

50 "Sec. 12 (a). In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

"First. All the ordinary and necessary expenses paid within the year * * *.

"Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; * * * (c) in the case of insurance companies, the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts; * * *.

"Third. The amount of interest paid within the year on its indebtedness. * * *

"Fourth. Taxes paid within the year * * *."

Section 4 of Title I, war income tax, of the act of October 3, 1917, so far as pertinent, provides:

"Sec. 4. That in addition to the tax imposed by subdivision (a) of section ten of such act of September eighth, nineteen hundred and

sixteen, as amended by this act, there shall be levied, assessed, collected, and paid a like tax of four per centum upon the income received in the calendar year nineteen hundred and seventeen, and every calendar year thereafter, by every corporation, joint-stock company or association, or insurance company subject to the tax imposed by that subdivision of that section, * * *.

"The tax imposed by this section shall be computed, levied, assessed, collected, and paid upon the same incomes and in the same manner as the tax imposed by subdivision (a) of section ten
51 of such act of September eighth, nineteen hundred and sixteen, as amended by this act. * * *"

It is noted that section 207 above, in its definitions, is both exclusive and inclusive.

The Government contends that all the legal reserve in question is excluded by this section, because, first, it is within its nonincluding paragraph, and second, because it is not within its including paragraph. The restrictive words of Title II, "War excess-profits tax," suggest a doubt that it could have been the legislative purpose to include mutual life insurance companies in the operation of the tax provisions of this title. These companies are not in business for gain, in the ordinary commercial sense. Their purpose is by cooperation to secure life insurance at cost. Excessive gains or profits are foreign to their purpose at any time, and war conditions are singularly likely to increase their losses without affording them any additional opportunity to increase their net gains. Experience has proven that a state of war increases the burdens of life insurance companies greatly in excess of those imposed on other kinds of business.

In the revenue act of March 3, 1917, an additional tax on the income of corporations, under the head "Excess-profits tax," was authorized. This country's entrance into the World War, following shortly thereafter, necessitated a larger revenue than contemplated when that act was passed. The bill which culminated in the act of October 3, 1917, repealed all the sections composing Title II, "Excess-profits tax," of the act of March 3, 1917, and as passed by the House did not contain the word "war" in the title dealing with excess profits. This word, used as indicating a reason for increased revenue, appears for the first time in the revenue act of
52 October 3, 1917, and was the result of amendments reported to the Senate by its Finance Committee, which, in support of the amended bill, said:

"It is estimated that the House bill will raise from excess-profits taxes an additional amount of $200,000,000, while it is estimated that the bill as amended by your committee will raise from war-profits taxes an additional amount of $562,000,000.

"After mature consideration your committee reached the conclusion that, in view of the large amount to be raised and the enormous war profits, amounting to nearly $3,000,000,000, shown by the income-tax returns of corporations for 1916, which amount will un-

doubtedly be increased for the year 1917, due in the main to war and war conditions, $562,000,000 was not an unreasonable *additional* amount to ask from the industries whose earnings have been so greatly augmented by the conditions which made necessary the call for this additional revenue.

* * * * * * *

"Your committee accordingly proposes the repeal of the existing war-profits tax law, and the substitution for both it and the additional war-profits tax passed by the House of a tax upon a basis similar to that followed by the European countries in which such taxation has been carried out with marked success. The committee proposes, instead of an excess-profits tax, a war-profits tax. In general, it proposes to make the basis of the tax the difference between the profits of the pre-war period and the profits of the taxable year. We take by taxation, directly or indirectly, for the purposes of war, a part of the extra gains which war itself has caused."

Here is an unequivocally expressed declaration that the extra
53 gains made out of conditions produced by the war should bear the extra governmental expenses incident to it, and that the standard for comparison should be the profits of the pre-war period, which the act (sec. 200), as noted, defined as the calendar years 1911, 1912, and 1913. This declaration by the Senate Committee, as the reason for imposing a war excess profits tax, tends to show that Congress, when it dealt with the "war excess profits tax" provisions of the act of October 3, 1917, did not have in mind enterprises of the character of mutual life insurance companies whose business it is to provide its members with insurance at cost, and which could not make extra gains as a result of war conditions, but, on the contrary, by reason thereof, were bound to suffer increased losses on account of war casualties and epidemics of diseases which usually follow in war's wake, as well as increased expenses in conducting their business.

An examination of the returns made by the plaintiff for the years 1911 to 1917, inclusive, for Federal income tax purposes, discloses that while both its gross income and expenditures steadily increased, the increases were quite conservative, the average increase from 1913 being less than 7%. The return for 1918, on the contrary, shows that while the gross income increased at about the same rate, the increase in expenses and losses over 1917 exceeded 12%. While the end of military operations in 1918 necessarily limited the scope of the comparison for this purpose, yet even this short period confirms the concept that a life insurance company is more likely to lose than gain during a war period; more likely to have excessive losses than excessive profits.

None of the plaintiff's assets during 1917 yielded a greater income than 6 per centum per annum, and the average rate of interest or return on its invested assets for many years was less than that percentage.

Mutual insurance companies are not in business or trade in
54 the ordinary acceptation of these terms. They are distributors, not producers, of wealth. Their business is, as stated, to insure its members at cost. In this business some gains are planned and expected, but only to reduce the cost of insurance. To this end the premiums—the only primary source of revenue—are purposely made larger than the calculated bare cost of insurance. This excess is invested and the income thereof compounded. Whatever the gains, they are distributed not as dividends in the ordinary sense, but to reduce the cost of insurance to the members. Gains of that kind, even if they exceed anticipation, are not of the character sought by the tax acts under consideration. True, it is possible that for a given year, by reason of increased income—premiums and interest—on the one hand, and unlooked-for decreases in losses and expenses on the other hand, the net income may be larger. However, the income, whatever its source and whatever its size, is subject to Federal income taxes. Under the ruling of the Commissioner, presently to be more particularly referred to, such parts of this income as exceed debts, liabilities, and payments to legal reserve, became invested capital within the meaning of the excess profits tax provisions of the act of October 3, 1917.

Under other titles of this act the rate of the ordinary income tax was considerably increased, but under Title II Congress reached out for and taxed only such income as represented excessive profits. In that title (sec. 203), as noted, it decided that a profit of between 7% and 9% on invested capital was not excessive. In construing the sections under Title II regard must be had to this legislative purpose and decision. So regarded, it is manifest that the excess profits tax was sought only from those who, notwithstanding the payment of the increased ordinary income tax, would still be possessed of excessive profits.

Under this revenue act, the basis, or starting point, for de-
55 termining whether an excess profits tax should be paid, is the net income subject to the ordinary tax under Title I, Part II, of the act of September 8, 1916. The plaintiff in its tax return for the year 1917 reported its total gross income at $42,893,564.95, made up as follows:

"3 (a) From premiums	$31,788,744.28
(b) Income from rentals	103,633.39
(c) Income from interest	9,821,630.74
(d) Income from dividends	0.
(e) Income from all other sources	1,179,556.54
Total gross income	43,893,564.95"

Among the deductions authorized by that act in ascertaining the net taxable income in the case of insurance companies, and the only one that needs special mention, is "the net addition, if any, required by law to be made within the year to reserve funds." (Sec. 12 (a), second (c).) In the return in question this amounted to the sum of

$14,557,131. The Government does not dispute the correctness of this amount of net addition, nor any of the items constituting the gross income thus reported. From this return it is noted that of the total gross income for 1917, $31,788,744.28 is from premiums and $9,821,-630.74 and $103,633.39 is from interest and rents, respectively.

In amending the plaintiff's excess profits tax return the commissioner, applying sec. 203 (a), above, allowed only $9,657,529.56 as its average invested capital for the pre-war period, and calculated its average taxable income for such period at $869,678.46, or 9.005%. In computing this average he refused to allow any of the legal reserve as part of the invested capital for the pre-war period, and in fixing such capital for the year 1917 he, of course, adhered to the same ruling, with the result that, as before stated, the invested capital for that year, as computed by him, was reduced from $202,-
56 685,846.45 to the sum of $14,719,043.76. This sum is less than $5,000,000 more than the total income received from the actual invested assets of the company for that year; such income equalling 67.42% of the amount allowed as invested capital. As noted, so much of this reserve as was not interest from invested assets was obtained from the members of the corporation—policyholders—in the shape of premiums. These premiums were deliberately made larger to permit of a part being applied to the legal reserve. By such contribution the palintiff's only capital fund was created and maintained. Without such redundancy of premiums the plaintiff could not have either complied with the statute requiring such reserve, or produced the nearly $10,000,000 interest which swelled the income on which it paid a Federal income tax.

To pay the income derived largely from an invested fund and deny that the fund is invested capital is neither logical nor consistent, and such a result should not be allowed, unless the statutory definition permits of no other course. This the Government does not dispute. It insists, however, that the statutory definition requires such exclusion. In its exclusive provision, as already noted, it is declared that, as used in this title, invested capital does not include—"stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title nor money or other property borrowed. * * *"

Concerning this feature of the definition, the Government contends that, as the net additions to reserve fund were deducted in ascertaining the net income subject to normal tax, it can not be treated as invested capital, for the reason that these additions are "other assets, the income from which is not subject to the tax imposed by this title."

On the other hand, the plaintiff insists that "the character of
57 the asset and not the use to which the income derived therefrom is put determines whether the asset shall be excluded from 'invested capital' and, furthermore, that the income from the reserve does not escape taxation."

At the outset, in considering this contention of the Government, it should be observed that the net additions made in 1917 are not part of the legal reserve which the plaintiff seeks to have allowed as invested capital. This reserve is made up solely of net additions of preceding years. Plaintiff has been doing business since 1845, and created and maintained a policy reserve for more than a quarter of a century before the New Jersey statute (P. L. 1872, pp. 8, 30) required it. During its earlier years, with few exceptions, the plaintiff's premiums furnished the larger contribution to this reserve, while during its later years the interest contributions to this fund exceeded those derived from premiums.

The income obtained from the investment of this legal reserve furnished nearly 80% of the income other than that obtained from premiums, and was so reported in item 3c of its return for normal Federal tax purposes, and no deduction thereof, as such, was claimed or allowed. The fact that the "net additions to reserve fund" made in the year 1917 were deducted in determining the net income of plaintiff subject to the normal tax of that year does not support the Government's contention that this legal reserve is "assets, the income from which is not subject to the tax" in question. Neither does the fact that a part of the interest obtained from the invested reserve was appropriated to such net additions furnish additional support for such contention. The entire addition could have been taken as well from premiums received. The particular source from which the net additions are made up is not important; the controlling fact on this branch of the injury is that all the income derived from the legal reserve was reported as income subject to tax-
58 ation and was so subjected. The legal reserve, therefore, is not within the part of sec. 207 which declares what shall not be included as "invested capital." What Congress seemingly had in mind in this general reference to "assets," the income whereof was not subject to excess-profits tax, was obligations of States and municipalities, other than bonds, such as short-term notes, which share with these bonds immunity from Federal taxation.

The Government next contends that this reserve is not within that part of section 207 (par. (a)), which declares what shall be "invested capital" for like purposes. This paragraph declares, as noted, that in the case of corporations such capital includes—

"(1) actual cash paid in, (2) the actual cash value of tangible property paid in other than cash for stock or shares in such corporation * * * at the time of such payment * * * and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year."

All three subdivisions of this paragraph are readily applied to corporations having capital stock, but their wording is inept to mutual corporations, which have no such stock. Subdivision (2) concededly is not applicable. As applied to a stock corporation subdivision (1)

includes only cash paid for capital stock, as cash paid in to surplus is made capital by subdivision (3), and this latter subdivision, similarly applied, is restricted to cash paid in to surplus and earned surplus or undivided profits used or employed in the business. But, inept as the language of these subdivisions is, when applied to mutual life insurance companies having no capital stock the Government insists that such companies are subject to the excess-profits tax provisions of this act, and further that unless this legal reserve can be brought within one or the other of these subdivisions,
59 it can not be treated as invested capital, and still further that such reserve is not comprehended within any of such subdivisions. As noted, sec. 200 of the same title (War excess-profits tax) declares that the term "corporation" as used in that title includes "insurance companies." Except for such inclusion there seemingly would not be even a plausible ground for the effort to include income derived from life-insurance business within the grasp of the excess-profits tax provisions of the act. But as there are capital-stock insurance companies that insure against fire and marine, as well as life, risks, something more than this definition is needed to bring mutual life insurance companies within the tax provisions of this title.

The very ineptness of the language of paragraph (a) of sec. 207 tends to support the plaintiff's contention that Congress had no purpose to subject mutual insurance companies to this war excess-profits tax, and that the insurance companies embraced in the definition of sec. 207 were confined to stock insurance companies. However, as mutual life insurance companies are not expressly excluded from the excess-profits tax provisions of the act, and assuming for the sake of argument that Congress had no intention of so excluding or exempting them, it must be further assumed that Congress did not intend to exclude them from the benefit of paragraph (a) of this section, notwithstanding its ineptness, if they had capital the income from which was subject to the excess-profits tax provisions of the act. For in this connection it must be emphasized that the relation of invested capital and net income lies at the very base of what is excess profit.

The Government concedes that all the plaintiff's assets over and above the legal reserve are invested capital within the meaning of such section, and the Commissioner's determination that the plaintiff had $14,719,043.76 as invested capital is based on such concession.
It insists, however, that this sum embraces all the assets of
60 plaintiff that fit in with the terms of subdivision (3), par. (a), of that section, and that that is the only subdivision which could be made applicable to such company.

To my mind the Commissioner's segregation of the plaintiff's assets into legal reserve and surplus is unsubstantial, and his determination that only the surplus constitutes the statutory "invested capital" is erroneous. Such a ruling, as pointed out by the plaintiff,

would produce strange results. The company which kept its premiums closest to the mathematical computation of cost would have the smallest surplus—Commissioner's invested capital—the largest earnings pro rata, and pay the largest excess-profits tax, while the company which secured the largest surplus through a liberal loading of the premiums would obtain the smallest earnings pro rata and pay the smallest excess-profits tax. In the absence of compelling reasons such an incongruous and inequitable result is not to be imputed to Congress. I fail to see how this so-called surplus of the plaintiff's assets may be held to be invested capital as paid in or earned surplus or undivided profits used or employed in the business if the legal reserve is not. True, the legal reserve is required by law, while the other assets are not so required, and the company has less control over the disposition of the legal reserve than over its remaining assets. But these facts furnish no basis for excluding the former from and including the latter in "invested capital." Both have a common source—namely, premiums paid in by the policyholders and income derived from investments. So much of each of these classes of assets as represents premiums is actual cash paid in to the insurance company by its members. These members—policyholders—are analogous to shareholders in a stock corporation. Subdivision (1), par. (a), of sec. 207 of the revenue act of 1917 is not expressly restricted to cash paid for shares of stock, and if mutual insurance companies are to be subjected to the imposition of war excess-profits taxes, then by analogy so much of the premium
61 payments made by such members, which is in excess of the actual cost of the insurance, should be held to come within such subdivision and be treated as "invested capital."

That Congress in the revenue act of 1918 amended this subdivision and expressly restricted it to cash paid in "for stock or shares" (sec. 326 (a) 1) affords no reason for holding that subdivision (1), as it stood in the 1917 act, must be so limited when applied to mutual insurance corporations. This added limitation is a distinct legislative recognition that without it the cash contribution to capital would not be so restricted. However, if it be given a retroactive effect as a legislative construction of the act of 1917, as contended by the Government, that would not prevent the application of the analogy just invoked. This subdivision would not, then, stand on the same basis as subdivision (2), admittedly inapplicable to the plaintiff, because this latter subdivision is further restricted to "tangible property," as the consideration given in payment for shares of capital stock, which does not find an equivalent or counterpart in any portion of the premiums paid by a member—policyholder—of a mutual life insurance company.

This reasoning by analogy in relation to subdivision (1) in principle is applicable to subdivision (3) of the same paragraph, which declares that the "paid in or earned surplus and undivided profits used or employed in the business" are invested capital. The surplus

here referred to is not to be construed as meaning one and the same thing—namely, earned surplus paid in. This subdivision is in the alternative and includes paid-in surplus, whether earned in the business or not. It frequently happens that shareholders—members—of a stock corporation, to augment the capital beyond that paid for shares of stock issued, contribute cash to create a surplus fund.

LaBelle Iron Works *v.* United States, 256 U. S. 377, 399.

62 While this, when so paid, is usually done at the beginning of the enterprise, there is nothing to prevent its being repeatedly done. The individual premiums paid by a policyholder of a mutual life insurance company, as already stated, being intentionally made larger in amount than supposed to be necessary to defray the actual cost of insurance, it follows that they cover more than protection. Included therein is something for investment, differing radically in this respect from premiums paid for fire, marine, or casualty insurance. Penn Mutual Co. *v.* Lederer, 252 U. S. 523, 533–4. This portion paid as investment is retained by the company, and so much thereof as is added to legal reserve so continues until the policy matures or is surrendered. No dividends are paid out of this reserve during the continuance of the life of the policy, but it is kept invested and reinvested to mature the outstanding policies. It, as well as its increment, enures to the benefit of the policyholders, and this reserve, at all times while in the possession of the company, is capital invested or held for investment. Therefore, all that part of these premiums that is larger than necessary for cost insurance is, by analogy, paid in, either as capital or surplus, for the purpose of carrying on the insurance business in which the members are mutually engaged. As a part of these excess payments in premiums are carried into the legal reserve, at least so much of this reserve as represents redundant payments of premiums, becomes capital or surplus and falls within subdivisions (1) or (3), or possibly both, and are as much "invested capital" as any cash paid for shares by shareholders of a stock corporation, or earned or paid-in surplus used and employed by such corporation in its business.

The legal reserve of the plaintiff had been accumulating for more than 60 years before the first of the herein-mentioned Federal income tax acts was passed. Those for the years beginning January first of each, 1872, 1909, 1911, 1912, 1913, and 1917, and their

63 proportion of premiums and interest derived from policyholders and investment of its reserve, respectively, are as follows:

Year	Premium	Interest	Total reserve
1872	$15,561,155.37	$4,094,988.63	$19,656,144.00
1909	33,569,857.14	76,554,892.93	110,124,750.07
1911	39,979,811.50	85,174,674.20	125,154,485.70
1912	45,591,484.45	89,872,590.70	135,464,075.15
1913	49,610,074.71	94,543,867.98	144,153,942.69
1917	70,302,157.10	115,956,638.90	186,258,796.00

These years have been selected for the following reasons: The New Jersey Legislature first required life insurance companies to maintain a legal reserve in the year 1872; in 1909 corporations were first subjected to a Federal income tax; the years 1911, 1912, and 1913 constitute the pre-war period referred to in the act of October 3, 1917, and which years that act (sec. 200) declared to be the standard for comparison in determining what was an excess profit subject to an excess-profits tax; and the year 1917 is the taxable year in question.

Only since the passage of the act of August 5, 1909 (36 Stat. 112, c. 6), which imposed a Federal excise tax on corporations, has the matter of deducting annual net additions to legal reserve from gross income become relevant as to the status of legal reserve in the matter of Federal income taxes. Whether the net additions beginning with 1909, having been once deducted in ascertaining the net income subject to a Federal income tax, may be included as invested capital under the act of 1917, is not necessary for present determination. Such a situation does not exist as to the net additions made prior to 1909, for these additions, whatever their source, rendered no such service. At the beginning of that year the total legal reserve was the sum of $110,124,750.07, and the interest derived therefrom was subject to the Federal income tax in that and subsequent years.

64 While, in my judgment, no part of the reserve can be said to be "assets" the income from which is not subject to the tax imposed by the act of October 3, 1917, or any of the other Federal income-tax acts, certainly no part thereof as it existed in the beginning of 1909 can be said to be that kind of assets. Surely at that time, though it had been built up from the income (premiums and interest) of the company, it had become transmuted into capital for investment, and there is nothing in the act of 1917 which excludes it from its definition of "invested capital." In this connection it should be noted that of the total reserve held on January 1, 1909, the sum of $33,569,887.14 was contributed from premiums. While this contribution at one time was income, it was the aggregate of the overpayments of premiums and became, as elsewhere noted, cash contribution by the members of the plaintiff, to be used and employed by it in its business of life insurance, and may by analogy, without doing violence to the statutory definition referred to, be held to be "invested capital" when dealing with the excess-profits tax provisions of the 1917 act.

Again, it should be noted that in the beginning of the year 1872—the year when the New Jersey statute first required the maintenance of a legal reserve—the reserve amounted to the sum of $19,656,144, which added to the amount allowed by the commissioner, viz, $14,719,043.76, as invested capital, exceeds the sum of $25,500,000, an amount concededly sufficient to avoid the imposition of any excess-profits tax for the year 1917.

In thus reasoning I have not overlooked the efforts made by representatives of the mutual companies, including the plaintiff, before the United States Senate and House committee having charge of the revenue bills of 1917 and 1918, urging amendments which would exclude such companies from the excess-profits tax provisions or which would include the legal reserve as invested
65 capital; nor am I unmindful of the absence of any of such provisions in the revenue acts of these years. One can not be unimpressed with such efforts or the failure of these committees to accede thereto. However, as the committees made no report on these suggested amendments, we have no legislative views as to the merits of either proposition. Both these efforts by the representatives and the absence of any official recommendation by these committees on the subject of these suggested amendments afford a basis for contradictory inferences.

As to these efforts: One is left in doubt whether the companies' representatives were urging the amendments, because of the belief that without their insertion the legal reserve could not be treated as "invested capital," or to remove the basis for the interpretation given to these representatives by the Commissioner that under the terms of the bill legal reserve could not be considered as invested capital, which interpretation had been brought by them to the attention of these legislative committees. (Hearings before Senate Subcommittee on Finance, 64th Congress, 2nd Session, on H. R. 20573, p. 52; also hearings before Committee on Ways and Means, House of Representatives, on revenue act of 1918, Part I, pp. 791, 798, 802, 811.)

As to the attitude of these committees: They may have concluded that this reserve should not be considered as part of such capital, or they may have been of the opinion that the terms of the bills, properly interpreted, were ample to give it that status. The record of these hearings shows that several members of the Senate committee doubted that these excess profits tax provisions as drawn (and subsequently enacted) affected mutual life insurance companies, and that at least one of them doubted the soundness of the referred to interpretation of the Commissioner. (Ib. Hearings before Senate committee, pp. 52, 53.)

66 In considering this phase of the question, it must be kept in mind that under Title II of this bill, to which these suggested amendments were directed, Congress was reaching out for the large, if not inordinate, gains that had been made by many of the manufacturing and trading companies by reason of the war. In the Finance Committee's report to the Senate, in relation to this bill, it was stated that these gains amounted to nearly $3,000,000,000 in 1916 and that they were expected to be further increased in 1917. It is not improbable that these committees may well have shared the general belief that life insurance conducted on the mutual plan

could not make these gains and therefore would not be affected by the proposed excess profits tax.

However, irrespective of which of these differing inferences be drawn from these occurrences before the congressional committees when these prospective acts were before them for hearing and consideration, it is well settled that in the absence of formal reports from committees, explanatory of certain provisions of such acts, the meaning thereof is not to be determined from the debates in Congress pending their passage. United States *v.* Union Pacific R. R. Co., 91 U. S. 72; United States *v.* Trans-Missouri Freight Assn., 166 U. S. 290; Downes *v.* Bidwell, 182 U. S. 244; Binns *v.* United States, 194 U. S. 486; Standard Oil Co. *v.* United States, 221 U. S. 1; Penna. R. R. Co. *v.* International Coal Co., 230 U. S. 184; Omaha Street Ry. Co. *v.* Interstate Commerce Commission, 230 U. S. 324; Lapina *v.* Williams, 232 U. S. 78; Duplex Co. *v.* Deering, 254 U. S. 443; Russell Co. *v.* United States, 261 U. S. 515. A fortiori this must be so as to discussions before a congressional committee where no report is made in regard thereto.

Penn Mutual Life Ins. Co. *v.* Lederer, 252 U. S. 523, is not authority for a contrary canon of interpretation. The marginal
67 reference (p. 534) to briefs and statements filed with the Senate committee, was merely to show that the alleged unwisdom and injustice of excluding one class of corporations from a tax exemption clearly and deliberately allowed to another class, had been strongly pressed upon Congress. The later cases of Duplex Co. v. Deering, supra, and Russell Co. v. United States, supra, reiterate the rule above stated.

In my opinion the plaintiff, at the beginning of the year 1917, had invested capital within the meaning of the revenue act of October 3, 1917, exceeding the sum of $25,500,000. As it is conceded that if such capital reached that sum, no war excess-profits tax was due from the plaintiff for the year 1917, the motion to dismiss the plaintiff's complaint must be denied, and under the stipulation between the parties the plaintiff is entitled to judgment for the amount claimed.

68 The United States District Court

[Title omitted.]

Judgment

(Filed February 26, 1924)

This matter coming on to be heard upon the defendant's motion to strike out the amended complaint herein, and the arguments of the respective parties upon said motion having been heard, and the parties having stipulated in open court that the decision on said motion shall be a final disposition of the controversy in this court, and the

court having considered the matter and being of opinion that the defendant's motion to strike out the complaint should be denied, and being of opinion that under the stipulation aforesaid the plaintiff is entitled to judgment for the amount claimed by it with interest and having assessed the plaintiff's damages at the sum of $83,779.70, with interest thereon from June 18, 1920,

It is therefore ordered on this 26th day of February, 1924, that the defendant's motion to strike out the complaint herein be denied and that judgment final be entered against said defendant and in favor of said plaintiff for the sum of $83,779.70, with interest at six per centum per annum thereon from June 18, 1920, to date of payment.

On motion of

PITNEY, HARDIN & SKINNER,
Attorneys for Plaintiff.

Let the above rule be entered.

JOHN RELLSTAB,
Judge.

69 The United States District Court

[Title omitted.]

Certificate of probable cause

(Filed March 5, 1924)

Recovery having been had against the defendant, Charles V. Duffy, in the above-entitled cause, which cause was for an act done by the said Charles V. Duffy, as collector of internal revenue for the Fifth District of New Jersey, in the performance of his official duty:

It is hereby certified by the court that the said Charles V. Duffy acted therein under the directions of the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, in the collection of the money for which recovery is had and paid the same into the Treasury, and that there was probable cause for the act done.

Dated March 1, 1924.

JOHN RELLSTAB,
Judge.

70 In United States District Court

[Title omitted.]

Exceptions

(Filed April 28, 1924)

1. The court found that the legal reserve of a mutual insurance company is a part of its invested capital for the purpose of computing its excess-profits tax.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

JOHN RELLSTAB, [SEAL.]
Judge.

2. The court found that plaintiff in the beginning of the year 1917 had invested capital within the meaning of the revenue act of October 3, 1917, exceeding the sum of $25,500,000.

Defendant's counsel prays an exception to the court's finding and an exception is allowed and sealed accordingly.

JOHN RELLSTAB, [SEAL.]
Judge.

71 3. The court found that no war excess-profits tax was due from plaintiff for the year 1917.

Defendant's counsel prays an exception to the court's finding, and an exception is allowed and sealed accordingly.

JOHN RELLSTAB, [SEAL.]
Judge.

4. The court denied defendant's motion to strike out complaint.

Defendant's counsel prays an exception to the court's ruling, and an exception is allowed and sealed accordingly.

JOHN RELLSTAB, [SEAL.]
Judge.

5. The court allowed judgment to be entered in favor of plaintiff and against defendant.

Defendant's counsel prays an exception to the court's ruling, and an exception is allowed and sealed accordingly.

JOHN RELLSTAB, [SEAL.]
Judge.

72 In United States District Court

[Title omitted.]

Assignments of error

(Filed April 28, 1924)

And the said Charles V. Duffy, collector of internal revenue of the United States for the fifth district of New Jersey, defendant and plaintiff in error, by Walter G. Winne, United States attorney, and Walter H. Bacon, jr., assistant United States attorney, comes and says that in the record of proceedings and in the findings of the court in said cause by the said District Court of the United States for the District of New Jersey there is manifest error in this, to wit:

1. The court erred in finding that the legal reserve of a mutual insurance company is a part of its invested capital for the purpose of computing its excess-profits tax.

2. The court erred in finding that plaintiff in the beginning of the year 1917 had invested capital within the meaning of the revenue act of October 3, 1917, exceeding the sum of $25,500,000.

3. The court erred in finding that no war excess-profits tax was due from plaintiff for the year 1917.

4. The court erred in denying defendant's motion to strike out the complaint.

73 5. The court erred in allowing judgment to be entered in favor of plaintiff and against defendant.

WALTER G. WINNE,
United States Attorney.
WALTER H. BACON, JR.,
Assistant United States Attorney.

74 In United States District Court

Clerk's certificate

UNITED STATES OF AMERICA,
District of New Jersey, ss.

I, George T. Cranmer, clerk of the District Court of the United States of America for the District of New Jersey, do hereby certify that the foregoing is the transcript of record as stipulated on writ of error in the case of the Mutual Benefit Life Insurance Company, plaintiff, vs. Charles V. Duffy, collector of internal revenue, defendant.

In testimony whereof I have hereunto subscribed my name and affixed the seal of the said court at Trenton, in said district, this 5th day of June, 1924.

[SEAL.]

GEORGE T. CRANMER,
Clerk.
By L. M. ZARP, *Deputy.*

75 In United States Circuit Court of Appeals for the Third Circuit

No. 3182 (List No. 56). October term, 1924

CHARLES V. DUFFY, COLLECTOR, PLAINTIFF IN ERROR,
vs.
MUTUAL BENEFIT LIFE INS. CO., DEFENDANT IN ERROR

Argument and submission

And afterwards, to wit, on the seventh day of January, 1925, come the parties aforesaid by their counsel aforesaid, and this case being called for argument sur pleadings and briefs, before the Honorable Joseph Buffington, Honorable Victor B. Woolley, and Honorable

J. Warren Davis, circuit judges, and the court not being fully advised in the premises, takes further time for the consideration thereof,

And afterwards, to wit, on the second day of March, 1925, come the parties aforesaid by their counsel aforesaid, and the court, now being fully advised in the premises, renders the following decision:

76 In United States Circuit Court of Appeals

[Title omitted.]

Opinion

(Filed March 2, 1925)

In error to the District Court of the United States for the District of New Jersey

Before BUFFINGTON, WOOLLEY, and DAVIS, *Circuit Judges.*

Per curiam. The collector of internal revenue for the Fifth District of New Jersey assessed upon the plaintiff a war excess profits tax of $83,779.70. This tax resulted from the Government's theory that the plaintiff's legal reserve fund of $186,258,796 was not "invested capital" within the meaning of section 207 of the income tax act of October 3, 1917. In its return for the year 1917 the insurance company declared its invested capital to be $202,685,846.45, which included its legal reserve fund. In amending the return the collector excluded this fund and allowed only $14,719,043.76 as "invested capital." This made the plaintiff's percentum of income very high. It brought this suit to recover the excess profits tax on the ground that its reserve fund was a part of its "invested capital." If this position is sound it would greatly decrease the rate of income. The defendant moved to strike out the complaint. In disposing of this motion, Judge Rellstab held that the legal reserve fund was "invested capital" within the meaning of the act and that the tax was assessed on the wrong basis. We are in accord with his conclusions and affirm the judgment on his able opinion as expressing our views.

[File indorsement omitted.]

77 In United States Circuit Court of Appeals

[Title omitted.]

Judgment

(March 2, 1925)

In error to the District Court of the United States for the District of New Jersey

This cause came on to be heard on the transcript of record from the District Court of the United States for the District of New Jersey, and was argued by counsel.

On consideration whereof it is now here ordered and adjudged by this court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

J. WARREN DAVIS,
Circuit Judge.

[File indorsement omitted.]

78 In United States Circuit Court of Appeals

Mandate

(Filed April 16, 1925)

UNITED STATES OF AMERICA, *ss:*

The President of the United States of America, to the honorable the Judges of the District Court of the United States for the District of New Jersey, Greeting:

Whereas, lately in the District Court of the United States for the District of New Jersey, before you or some of you, in a cause between the Mutual Benefit Life Insurance Company, plaintiff (defendant in error), and Charles V. Duffy, Collector of Internal Revenue for the Fifth District of New Jersey, defendant (plaintiff in error), judgment was entered in the said District Court on the 26th day of February, 1924, which judgment is of record in the office of the clerk of the said District Court, to which reference is hereby made, and the same is hereby expressly made a part hereof, as by the inspection of the transcript of the record of the said District Court, which was brought into the United States Circuit Court of Appeals for the Third Circuit by virtue of a writ of error by Charles V. Duffy agreeably to the act of Congress in such case made and provided, more fully and at large appears.

79 And whereas in the term of October, in the year of our Lord one thousand nine hundred and twenty-four, the said cause came on to be heard before the said United States Circuit Court of Appeals on the said transcript of record and was argued by counsel:

On consideration whereof it is now here ordered and adjudged by this court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

PHILADELPHIA, *March 2, 1925.*

You, therefore, are hereby commanded that such execution and further proceeding be had in said cause, as according to right and justice, and the laws of the United States, ought to be had, the said writ of error notwithstanding.

Witness, the Honorable William Howard Taft, Chief Justice of the Supreme Court of the United States, at Philadelphia, the six-

teenth day of April, in the year of our Lord one thousand nine hundred and twenty-five (1925).

SAUNDERS LEWIS, Jr.,
Clerk of the U. S. Circuit Court of Appeals, Third Circuit.

[File indorsement omitted.]

80 In United States Circuit Court of Appeals

Clerk's certificate

UNITED STATES OF AMERICA,
Eastern District of Pennsylvania Third Judicial Circuit, Set.

I, Saunders Lewis, jr., clerk of the United States Circuit Court of Appeals for the Third Circuit, do hereby certify the foregoing to be a true and faithful copy of the original record and proceedings of this court in the case of: Charles V. Duffy, Collector, plaintiff in error, vs. Mutual Benefit Life Ins. Co., defendant in error, No. 3182, on file, and now remaining among the records of the said court in my office.

In testimony whereof I have hereunto subscribed my name and affixed the seal of the said court, at Philadelphia, this 5th day of May, in the year of our Lord one thousand nine hundred and twenty-five, and of the Independence of the United States the one hundred and forty-ninth.

[SEAL.] SAUNDERS LEWIS, Jr.,
Clerk of the U. S. Circuit Court of Appeals, Third Circuit.

○

45 Supreme Court of the United States

Order allowing certiorari

Filed June 1, 1925

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

63230—25

In the Supreme Court of the United States

OCTOBER TERM, 1924

CHARLES V. DUFFY, FORMER COLLECTOR OF Internal Revenue, petitioner
v.
THE MUTUAL BENEFIT LIFE INSURANCE Company
No. —

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, AND BRIEF IN SUPPORT THEREOF

The Solicitor General, on behalf of Charles V. Duffy, former Collector of Internal Revenue for the Fifth District of New Jersey, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Third Circuit entered in the above case on March 2, 1925, affirming the judgment of the District Court of the United States for the District of New Jersey.

STATEMENT OF THE CASE

This is an important test case involving practically every life insurance company in the United States.

Respondent is a New Jersey corporation, chartered in 1845 for the transaction of the business of life insurance on the mutual plan. It has no capital stock represented by shares and no stockholders as such, the policyholders of the company constituting the members thereof. The business is conducted on the "level premium plan," under which the natural premiums, which increase in proportion to the age of the insured, are leveled and a maximum premium is paid annually throughout the life of the policy. During the early years of the policy this premium is in excess of the current cost of insurance, and during the later years it is less than cost. The excess paid in the early years is carried as a "reserve" to mature the policy by maintaining the insurance in the later years when the level premium would be insufficient to meet the current cost of insurance on the natural premium plan.

This reserve is required by the laws of the various States in which the company does business. Its amount is computed annually by the Commissioner of Banking and Insurance of the State of New Jersey, whose computation is accepted by the other States, with the exception of Massachusetts, where an independent computation is made. On January 1, 1917, the reserve required by New Jersey was $186,258,796, and by Massachusetts, $185,638,632.

Under the provisions of Title I of the Revenue Act of September 8, 1916, as amended by Title I

of the Revenue Act of October 3, 1917, 40 Stat. 300, Chap. 63, respondent filed an income-tax return for the year 1917, and paid a tax of $108,500.36. It also filed, pursuant to the provisions of Title II of the Act of October 3, 1917, *supra*, an excess-profits return for the same year, showing no tax due or payable. In this return respondent included as part of its "invested capital" under Section 207 of said Act, and claimed a deduction under Section 203 of the Act, the amount of the legal policy reserve of $186,258,796, required by the State of New Jersey for the year 1917.

Upon audit of the excess-profits tax return the Commissioner of Internal Revenue deducted this sum from the "invested capital" of respondent on the ground that the reserve was a "liability" and should be excluded in computing "invested capital." This resulted in an assessment of $83,779.70 as an excess-profits tax, which was paid under protest, and this suit was instituted for its recovery. The District Court gave judgment for the plaintiff, and on writ of error the Circuit Court of Appeals for the Third Circuit affirmed the judgment.

QUESTION PRESENTED

Is the legal policy reserve of a mutual life-insurance company to be deducted as a liability in computing "invested capital" of the company within the statutory definition of that term contained in Section 207 of Title II of the Revenue Act of October 3, 1917?

THE STATUTES

The pertinent parts of Title II of the Revenue Act of October 3, 1917, 40 Stat., Chap. 63, pp. 300, 302–306, providing for the payment of a War Excess Profits Tax, are as follows:

> SECTION 200. That when used in this title—
>
> The term "corporation" includes joint-stock companies or associations and insurance companies;
>
> * * * * *
>
> SECTION 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income: [The percentages follow.]
>
> * * * * *
>
> SECTION 203. That for the purposes of this title the deduction shall be as follows, except as otherwise in this title provided—
>
> (a) In the case of a domestic corporation, the sum of (1) an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the pre-war period was of the invested capital for the pre-war period (but not less than seven or more than nine per centum of the invested capital for the taxable year) and (2) $3,000. * * *

SECTION 207. That as used in this title the term "invested capital" for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.

As used in this title "invested capital" does not include stocks, bonds (other than obligations of the United States), or other assets the income from which is not subject to the tax imposed by this title, nor money or other property borrowed, and means, subject to the above limitations:

(a) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year. * * *

REASONS FOR GRANTING THE PETITION

1. The Circuit Court of Appeals erred in holding with the District Court that the legal reserve of a mutual life insurance company which is a "liability" on policy contracts constitutes a part

of its "invested capital" within the statutory definition of that term, as provided by Section 207 of the Revenue Act of 1917, *supra.*

2. The court erred in not following the principles heretofore laid down by this court in *Penn Mutual Life Insurance Company* v. *Lederer,* 252 U. S. 523, and *La Belle Iron Works* v. *United States,* 256 U. S. 377.

3. This is a test case. It is the first time the question involved has arisen for judicial decision.

4. The case is one of great public interest and of great importance to the Government in the administration of the revenue laws. It affects every mutual life insurance company in the United States. If the decision remains unreversed, no excess-profits tax will be payable by any life insurance company, because the deduction permitted under the court's construction will be so large as to entirely eliminate such tax.

5. The amount involved in this and many similar cases now pending in the courts and before the Treasury Department is approximately $25,000,000. A determination of the question by this Court will establish a rule for the settlement of these cases.

Wherefore it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Third Circuit should be granted.

JAMES M. BECK,
Solcitor General.

ARGUMENT

I

For the "legal reserve" to be deducted it must fall within the statutory definition of "invested capital"

"Invested capital" as defined by Section 207 of the Revenue Act of 1917 differs in many respects from the ordinary meaning of the word "capital." (*Porter* v. *Lederer,* 267 Fed. 739, 740.) It is a statutory definition carefully restricted by both inclusive and noninclusive clauses. This was recognized by this Court in *La Belle Iron Works* v. *United States,* 256 U. S. 377, 387–388, where it is said that—

> Section 207 shows that Congress * * * designedly adopted a term—"invested capital"—and a definition of it. * * * The word "invested" in itself imports a restrictive qualification. * * *

Therefore in order for the legal reserve of a mutual life insurance company to be included in "invested capital" it must fall within the statutory definition of that term as found in subdivisions (1), (2), or (3) of Section 207 (a) of said Act.

Subdivisions (1) and (2), which relate to cash or other property paid in for stocks or shares, are clearly not applicable. As this Court said in *La Belle Iron Works* v. *United States, supra,* p. 388:

> Cash paid in, and tangible property paid in other than cash, are confined to such as

> were contributed for stock or shares in the corporation or partnership. * * *

And again, p. 389:

> It is clear that clauses (1) and (2) refer to actual contributions of cash or of tangible property at its cash value contributed in exchange for stock or shares specifically issued for it. * * *

This interpretation is in accord with Section 326(a) of the Revenue Act of 1918, which adopts the definition of "invested capital" of the 1917 Act except that subdivision (1) thereof reads "Actual cash bona fide paid in for stock or shares."

Respondent is a mutual life insurance company and has no capital stock represented by shares. Consequently its legal reserve is not "invested capital" within the meaning of subdivisions (1) and (2) of Section 207(a) of said Act.

The question, then, narrows down to whether the legal reserve falls within subdivision (3) of Section 207(a) and constitutes "paid in or earned surplus and undivided profits used or employed in the business."

II

The legal reserve of a mutual life-insurance company is not "paid in or earned surplus or undivided profits used or employed in the business"

Certainly the legal reserve of a mutual life insurance company is not "undivided profits." It is

not "profit" in any sense of the word. It is a sum certain set aside to meet an absolute "liability." It is essentially a trust fund belonging to the policyholders established to assure payment of the policy in full at death. (*Fink* v. *Northwestern Mutual Life Insurance Company,* 267 Fed. 968; *Blanchard* v. *Prudential Insurance Company,* 80 N. J. Eq. 209; *Connecticut Mutual Life Insurance Company* v. *Commonwealth,* 133 Mass. 161; *United States Life Insurance Company* v. *Spinks,* 29 Ky. Law Rep. 960; rehearing, 31 Ky. Law Rep. 185.)

It thus remains to determine whether the legal reserve constitutes "paid in or earned surplus." Congress has not attempted to define these words, but they necessarily exclude surplus which is not "paid in or earned." It is not all surplus used or employed in the business which is included in "invested capital," but expressly only such as is "paid in or earned." These words are significant. They necessarily exclude "liabilities."

There is a clear distinction between the "legal reserve," the "contingent reserve," and the "surplus" of a mutual life insurance company. The "legal reserve" is a fund set aside from premiums to meet the liability for payment of the policy when it matures. The "contingent reserve" is a part of surplus set aside to meet extraordinary conditions. "Surplus" is the profit earned over and above the liability represented by the "legal reserve." In its ordinary sense and

in accounting, "surplus" includes the entire overplus of "assets" over "liabilities." It is what remains after making provision for all "liabilities" of every kind. *Bank of Commerce* v. *Tennessee,* 161 U. S. 134; *Insurance Company of North America* v. *McCoach,* 224 Fed. 657; reversed on another point, 244 U. S. 585.

Being thus a "liability" the legal reserve should be deducted from the "assets" of a mutual life insurance company in determining the true surplus constituting "invested capital" within the meaning of the statute.

III

The legal reserve is a deferred liability and not an "asset" and does not constitute "invested capital" of the company

That the legal reserve of a mutual life insurance company is a fixed and definite "liability" is abundantly clear. It is not a contingent liability, but a present existing liability as absolute and certain as is the death of the insured. (*Carr* v. *Hamilton,* 129 U. S. 252, 256.)

The legal reserve is carried as a "liability" in the annual reports of every life insurance company to the various State insurance commissioners.

It has been held for the purposes of State taxation to be deductible as a "liability." Pursuant to a New Jersey statute providing for the taxation of mutual life insurance companies after de-

ducting "debts and liabilities," the Prudential Insurance Company presented a statement including among its liabilities "reserves on policies (New Jersey Commissioners of Insurance Valuation) $132,138,211." This was recognized by the highest courts of New Jersey as a proper deduction for State tax purposes. (*Mayor, etc., of Newark* v. *Board of Equalization,* 80 N. J. L. 258; affirmed 81 N. J. L. 416.)

If the legal reserve is to be deducted as a "liability" and not included in "surplus" for purposes of State taxation, how can it at the same time be "surplus" and "invested capital" for purposes of Federal taxation?

The rule of the New Jersey courts that the legal reserve is a "debt or liability" is also the rule in New York, where it is held to be a "liability" and not "surplus." (*Greeff* v. *Equitable Life Assurance Company,* 160 N. Y. 19; *Farmers' Loan & Trust Company* v. *Aberle et al.,* 19 App. Div. N. Y. 79; *In re Equitable Reserve Fund Life Association,* 131 N. Y. 354; *People* v. *Life Union,* 31 N. Y. S. 1120.)

The rule of the New Jersey and New York courts also prevails in other States where it is held that the reserve fund is a "liability" of the company. (*Equitable Life Insurance Company* v. *Board of Equalization,* 74 Iowa 178; *Hawkeye Insurance Company* v. *Board,* 75 Iowa 770; *Alabama Gold Life Insurance Company* v. *Lott,* 54 Ala. 499; *Michigan Mutual Life Insurance Company* v.

Common Council, 133 Mich. 408; *Commonwealth* v. *Berkshire Life Insurance Company,* 98 Mass. 25.)

It is, then, thoroughly established that the reserve fund of a mutual life insurance company is not an "asset" but an actual deferred "liability." Therefore, it can not constitute "paid in or earned surplus" or "undivided profits" within the definition of "invested capital" contained in Section 207 of the Revenue Act of 1917.

This interpretation finds support in the case of *Penn Mutual Life Insurance Company* v. *Lederer,* 252 U. S. 523, 534. In that case this court said that "the service performed in level-premium life insurance is both protection and investment." On page 531 an analogy was drawn between a savings deposit in a bank and the premium paid in insurance, Mr. Justice Brandeis saying:

> But in level-premium life insurance, while the motive for taking it may be mainly protection, the business is largely that of savings investment. The premium is in the nature of a savings deposit. Except where there are stockholders, the savings bank pays back to the depositor his deposit with the interest earned less the necessary expense of management. The insurance company does the same, the difference being merely that the savings bank undertakes to repay to each individual depositor the whole of his deposit with interest; while the life insurance company undertakes to pay to each member of a class

> the average amount (regarding the chances of life and death). * * *

The method adopted by the Commissioner of Internal Revenue in computing the "invested capital" of respondent company was the same as that used in computing the "invested capital" of a bank. In the case of a bank "deposits" are included among cash "assets," but for the purpose of determining the "invested capital" the amount of deposits is deducted as a "liability," and the net over and above liabilities constitutes "invested capital." Insurance premiums paid are part of the cash "assets" of the company, but the reserve is a part of those premiums set aside as "liability." Therefore, in computing the "invested capital" of a mutual life insurance company, the amount of the reserve should be deducted as a liability from the assets, and the "invested capital" is the net assets over and above the reserve liability.

IV

It was not the intent of Congress that the legal reserve should be included as "invested capital"

By section 200 of the Revenue Act of 1917, Congress made the excess-profits tax provisions of the Act applicable to all insurance companies.

When the first excess profits tax act of March 3, 1917, was under consideration representatives of the various life insurance companies appeared at the hearings of the Senate Subcommittee on

Finance and urged that the proposed excess profits tax would not allow the companies to consider as "invested capital" their reserve funds. It was also submitted that the companies had no actual "cash paid in" and that the only surplus was the contingent reserve over and above all liabilities, the "legal reserve" being considered as a liability and not an asset. (*Hearings Before the Senate Subcommittee on Finance, 64th Congress, 2nd session,* H. R. 20573, pp. 45, 48, 52, 60.)

When the Revenue Act of October 3, 1917, was under consideration an amendment was offered on behalf of life insurance companies to expressly include the legal reserve of a mutual life insurance company as "invested capital." (*Hearings before the Senate Subcommittee on Finance, 65th Congress, 1st Session,* H. R. 4280, p. 258.) This amendment was not adopted by Congress.

When the Revenue Act of 1918 was under consideration a similar amendment was again urged upon Congress. (*Hearings before the Committee on Ways and Means on the Proposed Revenue Act of 1918,* Part 1, pp. 800, 811.) This amendment was also not adopted by Congress.

This history is similar to that considered in *Penn Mutual Life Insurance Company* v. *Lederer,* 252 U. S. 523, involving exemption of life insurance companies from the provisions of the Income Tax Act of 1913, where this court said (p. 534):

> Congress exempted certain cooperative enterprises from all income taxation, * * *

> but * * * it imposed in express terms such taxation upon "every insurance company."
>
> Footnote 1. The alleged unwisdom and injustice of taxing mutual life insurance companies while mutual savings banks were exempted had been strongly pressed upon Congress. Briefs and statements filed with Senate Committee on Finance on H. R. 3321—Sixty-third Congress, First Session, Vol. 3, pp. 1955–2094.

So in this case the insurance companies repeatedly endeavored, without success, to prevail upon Congress to incorporate express language in three successive acts which would include the legal reserve in "invested capital." The consistent refusal of Congress to do so distinctly expresses its intent.

This intent is further shown by the exclusion of the legal reserve of life-insurance companies from capital-stock tax on surplus and undivided profits imposed by Section 407 of the Revenue Act of 1916. It is inconceivable that Congress intended the legal reserve to occupy a dual status—to be excluded from surplus and undivided profits for the purpose of capital-stock tax and yet be included as surplus and undivided profits, that is, "invested capital," for the purpose of the excess-profits tax.

Moreover, the net addition to legal reserve is not subject to income tax under Section 12 of the Revenue Act of September 8, 1916. The basis

of the excess-profits tax is "the net income of the taxpayer for the taxable year." The definition of "invested capital" contained in Section 207 expressly excludes therefrom "assets," the income from which is not subject to the excess-profits tax.

CONCLUSION

In view of the great importance of this case, it is respectfully submitted that the petition for certiorari should be granted.

JAMES M. BECK,
Solicitor General.

MAY, 1925.

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diction of this Court was invoked under Section 240(a) of the Judicial Code, and certiorari was granted June 1, 1925. (268 U. S. 686.)

STATEMENT

The Mutual Benefit Life Insurance Company, a New Jersey corporation, sued Duffy, Collector of Internal Revenue, to recover $83,779.70, with interest. The suit, brought in the Supreme Court of New Jersey, was removed to the United States District Court for the District of New Jersey on July 24, 1920. (R. 1.) The suit was to recover excess-profits tax for the year 1917 alleged to have been illegally exacted and paid under protest. Under the provisions of Title I of the Revenue Act of September 8, 1916, as amended by Title I of the Revenue Act of October 3, 1917 (c. 63, 40 Stat. 300), the respondent filed an income-tax return for the year 1917 and paid a tax of $108,500.36. (R. 5.) It also filed, pursuant to the provisions of Title II of the Revenue Act of October 3, 1917, an excess-profits return showing no tax due or payable.

In its return respondent included as part of its "invested capital" under Section 207 of said Act the amount of the legal policy reserve, $186,258,796, required by the State of New Jersey, and claimed a deduction on account thereof under Section 203 of the same Act. Upon audit of the return the Commissioner of Internal Revenue deducted this sum from the invested capital of respondent and also made certain other adjustments (not now in

dispute), the net result being an additional assessment of $83,779.70, to recover which the suit was brought. The case was heard in the District Court upon a motion to strike out the complaint. Judge Rellstab denied the motion, and under stipulation of the parties judgment was entered for the plaintiff for the amount claimed. Upon writ of error the Circuit Court of Appeals affirmed the judgment, which is now before this Court upon writ of certiorari granted upon the application of the Government to review the question stated in the petition, as follows:

QUESTION PRESENTED

Is the legal policy reserve of a mutual life insurance company to be deducted as a liability in computing "invested capital" of the company within the statutory definition of that term contained in Section 207 of Title II of the Revenue Act of October 3, 1917?

THE STATUTE

The pertinent parts of Title II of the Revenue Act of October 3, 1917, Chap. 63, 40 Stat., pp. 300, 302–306, providing for the payment of a War Excess Profits Tax, are as follows:

> Section 200. That when used in this title—
>
> The term " corporation " includes joint-stock companies or associations and insurance companies;
>
> * * * * *
>
> Section 201. That in addition to the taxes under existing law and under this act there

shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year; * * *

Section 203. That for the purposes of this title the deduction shall be as follows, except as otherwise in this title provided—

(a) In the case of a domestic corporation, the sum of (1) an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period was of the invested capital for the prewar period (but not less than seven or more than nine per centum of the invested capital for the taxable year), and (2) $3,000; * * *

Section 207. That as used in this title the term, " invested capital " for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.

As used in this title " invested capital " does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title, nor money

or other property borrowed, and means, subject to the above limitations:

(*a*) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year: * * *

THE FACTS

The Mutual Benefit Life Insurance Company is a New Jersey corporation and has conducted the business of mutual life insurance for many years. It has no capital stock and no stockholders. Its assets have all been contributed by its members in the form of premiums on policy contracts. It is a purely mutual company and has always conducted its business on what is known as the level premium plan. (R. 2.)

Under the level premium plan the estimated annual cost of each member's insurance is averaged and the maximum annual premium which he can be called upon to pay is uniform throughout the

life of the policy. A member contributes annually during his early years a sum in excess of the actual cost of carrying his insurance during those years. This excess, augmented by interest thereon, is held by the company as a reserve, which serves to maintain the insurance during his later years, when the level premium would otherwise be insufficient to meet the then cost of the insurance. (R. 2.)

The premiums referred to are the net or mathematical premiums without any provision for expenses or contingencies, to meet which an addition to the net premium is made called "loading." The net or mathematical premium increased by the "loading" constitutes the premium stipulated in the policy. At the end of each year the excess of income over disbursements is ascertained, and after setting aside so much of the excess as is required by law for the increase of the policy reserve each policyholder's share is ascertained and returned to him, either in cash or by credit upon his next annual premium. (R. 3.) The laws of the State of New Jersey and of all other States in which plaintiff does business require as a condition of continuing business that its assets shall not be less than the reserve required by law. (R. 3.)

The amount of the reserve for which the company is required to hold assets is computed annually by the Commissioner of Banking and Insurance of the State of New Jersey and his certificate is accepted by the Insurance Commissioners of all

other States in which it does business except Massachusetts, where the Commissioner makes an independent calculation. The computation of the reserve is based upon an assumed rate of mortality and an assumed rate of interest. The methods of computation are illustrated in Schedule E annexed to the complaint. (R. 8, 9.)

On January 1, 1917, the reserve as computed by the Commissioner of New Jersey was $186,258,796. As computed by the Massachusetts Insurance Department it was $185,638,632. (R. 3.)

A policyholder, while he continues a member of the company, has no right to withdraw a part of the reserve. On surrendering his policy he may ordinarily receive a certain sum in cash or in paid-up insurance and the allowance thus made is never in excess of the reserve. It is generally less, and in some circumstances no allowance at all is made. (R. 4.)

Plaintiff's return for the year 1917 showed a net income of $1,808,339.33, on which it paid an income tax of $108,500.36 and no excess-profits tax. Afterwards the Commissioner of Internal Revenue amended the return in several respects, which are set forth in detail on pages 5 and 6 of the record, and in schedules G, H, and I annexed to the complaint. The result was an additional tax of $83,779.70. The following compilation shows how the amount was computed:

EXCESS PROFITS TAX

Net income for taxable year reduced to		$1,781,815.64
Invested capital for taxable year	$14,719,043.76	
Percentage used in computing deduction	9 per cent	
Amount of deduction for invested capital	1,324,713.94	
Specific exemption	3,000.00	
Total deduction	1,327,713.94	1,327,713.94
Balance subject to excess profits tax		454,101.70
Rate of tax 20 per cent		20 per cent
Total excess profits tax due		90,820.34

INCOME TAX

Total net income for taxable year		1,781,815.64
Less: Excess profits tax		90,820.34
Balance subject to income tax		1,690,995.30
Amount of 2 per cent tax	$33,819.91	
Amount of 4 per cent tax	67,639.81	
Total income tax	101,459.72	101,459.72

SUMMARY

Total income tax for the year 1917	101,459.72
Total excess profits tax	90,820.34
Total taxes due	192,280.06
Original tax paid	108,500.36
Additional taxes paid	83,779.70

It was to recover the amount of this additional tax that the suit was brought, and no fault was found with any of the amendments made by the Commissioner except his deduction of the legal reserve from the amount claimed by the company as its "invested capital." Disregarding details not in dispute, the difference between the Company and the Commissioner of Internal Revenue over "invested capital" was this: The Company claimed that all its assets should be included in invested capital, the Commissioner allowed these assets

minus the reserve. R. 5; Schedule B. R. 7; Schedule H. facing R. 10.

The scheme of the act was to exempt from the excess-profits tax so much of the income for the year as represented the same percentage of invested capital as the "pre-war" income had been of the "pre-war" invested capital,—in any event, however, 7 per cent and in no event more than 9 per cent thereof.

The petitioner in its return made no report of pre-war earnings or pre-war invested capital. It returned its invested capital for the taxable year at $202,685,846.45 and claimed a minimum exemption or deduction of 7 per cent of that amount, which, of course, was far greater than its entire net income. (R. 5, 6.) The Commissioner, in amending the return, computed the Company's pre-war income and pre-war invested capital and found that the average pre-war income was slightly in excess of 9 per cent and allowed the Company a deduction of 9 per cent of its invested capital for the taxable year, together with the specific exemption of $3,000. In computing invested capital both for the taxable year and for the pre-war years the Commissioner refused to allow as part thereof the legal reserve. If the reserve had been allowed it is obvious that no excess-profits tax would have been due. The sole question litigated below and the sole question now before this Court is whether the legal reserve constituted invested capital within the meaning of the

act in question. The District Court held that it did. Counsel for the collector excepted and assigned that ruling as error. (R. 39, 40.) The Circuit Court of Appeals affirmed, and upon petition for writ of certiorari that was the sole question which we asked this Court to review.

SUMMARY OF ARGUMENT

The statute itself defines "invested capital," and to be included therein the legal reserve must fall within the statutory definition.

The legal reserve does not represent cash or tangible property paid in for stock or shares in the corporation, and so is not invested capital within the meaning of subdivisions (1) and (2) of paragraph (a) of Section 207 of the Act.

Nor is the legal reserve of a mutual life-insurance company surplus or undivided profits. It is a liability of the company, the amount of which is computed in accordance with principles fixed by law, and the amount thereof thus ascertained must be charged against the assets of the company as a liability before the company can in any sense be said to have a surplus or undivided profits. This is in accordance with well-understood and fundamental principles of mutual level-premium life insurance, principles recognized and enforced by insurance laws and by insurance departments of the various States. It is also consistent with other provisions of the same and other acts imposing taxes upon these companies. The legislative his-

tory of excess-profits legislation is confirmatory of the plain language of the statute and shows that Congress did not intend that the legal reserve should be regarded as part of the invested capital of life insurance companies.

ARGUMENT

I

To be included in invested capital, the legal reserve must fall within the statutory definition of that term

"Invested capital" as defined by Section 207 is purely a statutory concept. It is not synonymous with invested funds and is exclusive of many things ordinarily regarded as capital. It is a statutory definition restricted by both exclusive and non-inclusive clauses. *LaBelle Iron Works* v. *United States*, 256 U. S. 377.

For the legal reserve of a mutual life insurance company to be included in invested capital it must fall within the statutory definition of that term as found in Subdivisions (1), (2), and (3) of Section 207 (a). The opinion of Judge Rellstab, adopted by the Circuit Court of Appeals, shows clearly that his decision was based upon a reluctance to give the plain language of the statute its full application to the case of a mutual life insurance company. After quoting from a report of the Finance Committee of the Senate, he said (R. 29):

> This declaration by the Senate Committee, as the reason for imposing a war excess-profits tax tends to show that Congress, when

> it dealt with the "war excess-profits tax" provisions of the act of October 3, 1917, did not have in mind enterprises of the character of mutual life insurance companies whose business it is to provide its members with insurance at cost, and which could not make extra gains as a result of war conditions, but, on the contrary, by reason thereof, were bound to suffer increased losses on account of war casualties and epidemics of diseases which usually follow in war's wake, as well as increased expenses in conducting their business.

The courts, however, have no concern with the wisdom or justice of making mutual life insurance companies subject to the same measure of taxation as ordinary business enterprises. In *Penn Mutual Life Insurance Company* v. *Lederer,* 252 U. S. 523, this Court, having under consideration the Income Tax Law of October 3, 1913, c. 16, 38 Stat. 172, and its application to a purely mutual legal reserve company, issuing level premium insurance, said at page 534:

> Nor does the fact that the profit was earned by a cooperative concern afford basis for the argument that Congress did not intend to tax the profit. Congress exempted certain cooperative enterprises from all income taxation, among others, mutual savings banks; but, with the exception of fraternal beneficiary societies, it imposed in express terms such taxation upon " every insurance company."

To this sentence of the opinion the Court appended the following footnote:

> The alleged unwisdom and injustice of taxing mutual life insurance companies while mutual savings banks were exempted had been strongly pressed upon Congress. Briefs and statements filed with Senate Committee on Finance on H. R. 3321—Sixty-third Congress, first session, Vol. 3, pp. 1955–2094.

In the early part of 1917, when Congress was considering the revision of the Income Tax Act of September 8, 1916, by increasing the rate of taxation and by imposing for the first time an excess-profits tax, representatives of various insurance companies appeared before the committees of Congress and protested against increasing the rate of taxation on income and making applicable to them an excess-profits tax. (Hearings before the Senate Committee on Finance, 64th Congress, 2nd Session, on H. R. 20573, pp. 43 *et seq.*)

Exhaustive arguments were presented to the committees of Congress to show that mutual life insurance companies should not be subjected to an excess-profits tax. Congress nevertheless passed the Excess-profits Tax provisions of the Act of March 3, 1917, and included insurance companies without any exception as to mutual companies, and the Act of October 3, 1917, levied an additional income tax of 4 per cent and imposed an excess-profits tax applicable to all insurance companies.

Section 200 of the Act makes the War Excess-Profits Tax applicable to "insurance companies," and Section 201 makes the title apply "to all trades or businesses of whatever description," except those specifically exempted.

It is not claimed, however, that mutual life insurance companies are included in the excepted clauses. Congress did not see fit to draw any distinction between mutual life insurance companies and other corporations in the Act we are now considering, or any prior income-tax legislation. There is no warrant in law for claiming that the definition of invested capital, contained in Section 201 (a), does not apply to mutual life insurance companies and no sound reason has yet been advanced for not applying the definition literally to such companies.

II

The legal reserve of a mutual life insurance company does not fall within the statutory definition of invested capital, as found in subdivisions (1) and (2) of section 207(a)

To be included in Subdivisions (1) and (2) invested capital must be either cash or tangible property paid in for stock or shares of the corporation. *LaBelle Iron Works* v. *United States,* 256 U. S. 377. In that case this Court, referring to this section said, at page 388:

> Cash paid in, and tangible property paid in other than cash, are confined to such as were contributed for stock or shares in the corporation or partnership; * * *.

And again, at page 389:

> It is clear that clauses (1) and (2) refer to actual contributions of cash or of tangible property at its cash value contributed in exchange for stock or shares specifically issued for it; * * *.

This interpretation is in accord with Section 326 (a) of the Act of 1918, Act of Feb. 24, 1919, ch. 18, 40 Stat. 1057, 1092, which adopts the definition of invested capital of the 1917 Act, except that subdivision (1) thereof reads "Actual cash bona-fide paid in for stock or shares."

Inasmuch as the respondent company is a mutual company having no capital represented by stock or shares, its legal reserve is not invested capital within the meaning of subdivisions (1) and (2). If it is to be considered invested capital, therefore, it must fall within the description contained in subdivision (3)—that is, it must be "paid in or earned surplus and undivided profits" used or employed in the business.

III

The legal reserve of a mutual life insurance company is not paid in or earned surplus or undivided profits

The terms surplus and undivided profits in section 207 are evidently used in the ordinary sense. Compare *Edwards* v. *Douglass*, 269 U. S. 204, footnote, p. 215.

To regard the legal reserve of a life insurance company as surplus or undivided profits is to be

wholly unmindful of the fundamental character of level-premium life insurance. Whatever the reserve is, it is not surplus, and it is not undivided profits. If it is, all the modern laws relating to the subject have failed in their purpose and many of the supposed reforms which have been brought about in the conduct of these companies during the past twenty years are imaginary rather than real. According to every known standard of modern insurance accounting or of statutes regulating insurance, an impairment of the legal reserve renders the company insolvent, and to prevent the accumulation of excessive surpluses and undivided profits, (an evil once prevalent), has been one of the chief objects of recent legislation relating to life-insurance companies. There can be no such thing as surplus or undivided profits except such as exist over and above an unimpaired reserve. This is fundamental.

The "legal reserve" at the end of any year is the amount required to meet the liability of the company shown by the "net value" of its policies at that time. Mutual life insurance companies are purely cooperative associations in which each policyholder pays, as nearly as can be computed, the actual cost of the benefit which his contract gives him.

The net or mathematical premium is calculated by taking the duration of life as shown by an accepted mortality table and assuming a given rate of return upon investments. The result is the ex-

act amount which each member of a given class must pay annually in advance, in order to put and keep the company in funds which will enable it to pay, as they mature, all policies of those in the class. To the net or mathematical premium thus computed is added an amount called " loading," to cover expenses of management, contingencies, etc., and the sum is the amount of the annual premium stipulated in the policy. (R. 3.) The legal reserve on any policy at any time (the equivalent of the " net value " of the policy) is the amount of the net premiums theretofore paid on the policy plus interest thereon at the assumed rate, less the cost of carrying the insurance up to that time. It may be computed in either of two ways, producing the same result.

Schedule E, annexed to the complaint (R. 8 and 9), illustrates the two methods of computation. The so-called retrospective method is the method just described. The prospective method (R. 9) is found by deducting the value of all future net premiums from the present value of all policy obligations. See *Moir, Life Assurance Primer,* p. 148; *Eldridge, Principles of Reservation; Fackler, Notes on Life Insurance,* p. 33; *Principles and Practices of Life Insurance,* 8th Ed., (The Spectator Co.), p. 24.

The policy reserve of a life insurance company, together with the value of the future net premiums to be received, represents as nearly as human wis-

dom can calculate it the exact equivalent of the obligation existing at the moment under its policies—an obligation literally as sure as death itself. The reserve calculated in accordance with the experience tables of mortality and the income rate adopted by the company or prescribed by the laws of the State and maintained year by year is what stands between the company and insolvency. An unimpaired reserve is a condition precedent to the continuance of business. (R. 3.) It is only such assets as the company may have over and above this reserve that can ever be regarded in any sense of the word as surplus or undivided profits. That many people believed that it was unwise or unjust for Congress to subject these companies to the excess profits tax can not alter that fact. On the contrary, the fact was a ground for the belief.

The historic Report of the Joint Committee of the Senate and Assembly of the State of New York appointed to investigate the affairs of life insurance companies (Assembly Document No. 41), transmitted to the Legislature February 22, 1906, contains (pp. 418–429) an exhaustive discussion of the surplus of insurance companies. We quote from the Report, page 418:

> A mutual company is based upon the operation of the law of averages. While the duration of the life of any one person is uncertain, the number of deaths which will annually occur among a large number of persons may be predicted almost to a cer-

tainty. Assuming a given rate of mortality based upon experience and a given income from the investments of funds, calculations are made of the amount which should be paid to meet the cost of insurance in a particular case. An additional amount is added to cover estimated expenses and to provide for contingencies, and the result is the fixed premium required. If the actual rate of mortality exactly coincided with the expected rate, if the company realized exactly the anticipated income and if the expenses and contingent necessities corresponded exactly to the provision therefor, there would be no surplus and hence no dividends. The policy holder would receive the insurance bargained for and nothing else.

The Report goes on to point out that the gains of life insurance companies are of five classes:

(1) From mortality due to the difference between the actual and the expected mortality.

(2) From interest or income larger than that expected.

(3) From lapses by reason of a less amount being paid upon lapsed policies than the accumulation arising from the premiums paid.

(4) From loading by reason of expenses and contingencies being less than anticipated.

(5) Profits from sale of property or liquidation of investments.

The Report then continues:

> These gains simply represent the amount which the policyholder has been overcharged for his insurance. In a mutual company or a stock company transacting business upon the mutual plan and issuing participating policies the policyholder is entitled to an equitable return of the overcharge and this is accomplished by the payment of dividends.

The only surplus or undivided profits which a mutual life insurance company may have, therefore, are such as accrue by reason of the fact that the premiums charged are greater than is necessary to pay the claims and maintain the reserve. Most companies in recent years, either because required by law to do so or because of an enlightened policy, distribute these gains annually or at other short periods, either in cash or by credit upon the next annual premium, and this is what is done by the petitioner. (R. 3.) This, of course, does not mean literally that every dollar above the legal reserve is returned and the company reduced to a condition of mere technical solvency. A reasonable "surplus" or special or contingent reserve to meet contingencies is carried for safety. The annual report of the respondent to the Insurance Department of New Jersey showed a surplus of this kind on December 30, 1916, of $8,935,262.05. (See Report of Supt. of Banking and Insurance for year ending December 30, 1916, Part II, p. 21.) This was considerably less than the amount of invested

capital allowed by the Commissioner of Internal Revenue.

In New York as the result of the investigation to which reference has been made companies were required to make annual distribution of these gains and the amount which could be accumulated in the form of a surplus or contingent reserve was carefully restricted. (New York Insurance Law, Section 87; Consolidated Laws, Ch. 28.)

Under the laws of New Jersey when the assets of a life insurance company are not equal to the " net value" of its outstanding policies and other liabilities, the Commissioner of Banking and Insurance may apply for a receiver to wind up the company. (Comp. Stat. of New Jersey, page 2854, Sec. 56.)

Section 86 of New York Insurance Law, c. 28, Consolidated Laws of New York, provides that in estimating the condition of any life insurance company there shall be charged as a liability in addition to the capital stock and all outstanding indebtedness " the premium reserve on policies, and additions thereto in force computed according to the table of mortality and rate of interest prescribed in this act."

The two items which make up the sum of $186,-258,796, which the Commissioner of Internal Revenue refused to allow as invested capital because it was the amount of the reserve liability are set forth under the head "Liabilities" in the annual report of the Commissioner of Banking and Insur-

ance of the State of New Jersey for the year ending December 30, 1916, Part II, page 18. (Compiled Statutes of New Jersey, page 2862, Section 75, requires the Commissioner of Banking and Insurance to make an annual report to the Legislature containing an abstract of the statement of every insurance company filed in his department as required by law.) So far as we have been able to discover, the legal reserve is universally carried as a liability in reports of all life insurance companies. The legal reserve is not a contingent liability but a present existing liability as absolute and certain as is the death of the insured. (*Carr* v. *Hamilton*, 129 U. S. 252.) In that case this Court said, at page 256:

> Every person's interest in life insurance is capable of instant and present valuation, almost as certain and determinate as the discount of a note or bill payable in the future. Tables of mortality and of all values dependent thereon are adopted by every company, and furnish an assured basis of computation for this purpose.

To say, therefore, that the legal reserve of a mutual life insurance company is in any sense surplus or undivided profits is to disregard the essential principles underlying the business recognized by the State Insurance Laws and Insurance Departments. See *National Life & Accident Insurance Co.* v. *Craig*, 251 Fed. 524; *Fink* v. *Northwestern Life Insurance Co.*, 267 Fed. 968.

By a supplement to the General Tax Act of New Jersey, approved May 11, 1906, P. L. 418, life insurance companies are assessed and taxed upon the value of their property and entitled to deduct from the amount the value of their debts and liabilities, including in their liabilities the "value" of their policies according to the computation made by the Commissioner of Banking and Insurance. See *Mayor, etc., of Newark* v. *State Board of Equalization,* 81 N. J. L. 416.

If the amount of the legal reserve is deductible as a liability for purposes of State taxation, how can it at the same time be surplus and undivided profits for purposes of Federal taxation? The rule of New Jersey that the legal reserve represents a debt or liability is also the rule of New York, where it is held to be a liability and not surplus. *Greeff* v. *Equitable Life Assurance Society,* 160 N. Y. 19.

The rule of New York and New Jersey also prevails in other States, where it is held that the reserve fund is a liability of the company. *Equitable Life Ins. Co.* v. *Board of Equalization,* 74 Iowa, 178; *Hawkeye Ins. Co.* v. *Board of Equalization,* 75 Iowa, 770; *Alabama Gold Life Ins. Co.* v. *Lott,* 54 Ala. 499; *Michigan Mutual Life Ins. Co.* v. *Common Council of Detroit,* 133 Mich. 408; compare *Commonwealth* v. *Berkshire Life Ins. Co.,* 98 Mass. 25.

The reserve of a life-insurance company is no more surplus and undivided profits than are the

deposits in a bank. The annual addition made to the reserve does not represent an addition to its surplus and undivided profits any more than does the increase in deposits of a bank. While the amounts deposited in a bank belong to it in the sense that it has title to them, and are loaned and invested by the bank, and in that sense are invested funds, nevertheless against them must be charged as a liability all that it owes to its depositors. And it is only such assets as remain after its obligations to its depositors have been charged as a liability that represent in any sense surplus or undivided profits—that is, invested capital within the meaning of Section 207 of the Act we are considering. The net additions made each year to the reserve represent the then value of the net additions made to its liabilities. The analogy between the premiums in level-premium life insurance and deposits in savings banks was recognized in *Penn Mutual Life Ins. Co.* v. *Lederer*, 252 U. S. 523, 534. The method adopted by the Commissioner of Internal Revenue in computing capital of the respondent company was the same as that used in computing the invested capital of a bank. In the case of a bank the deposits are included as assets, but for the purpose of determining the invested capital the amount of the deposits is deducted as a liability. So from the assets of the Insurance Company must be deducted the "value" of its

policies—that is, of its obligations to its policyholders, in other words its reserve, before it can be said to have any surplus.

This construction of Section 207 is consistent with the provisions of the Capital Stock Tax Act and the income-tax provisions of this and other acts permitting insurance companies to deduct from gross income the annual net additions to the legal reserve.

Section 407 of the Revenue Act of September 8, 1916 (c. 463, 39 Stat. 756), provides for the payment of a capital stock tax by corporations, including insurance companies, based upon the fair value of capital stock, including surplus and undivided profits. The Act, however, contains a proviso that the legal reserve shall not be included as part of surplus and undivided profits for the purpose of the tax, the proviso being:

> *Provided,* That in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders shall not be included.

In the case of foreign insurance companies, the tax is levied on the capital actually invested in the transaction in the business in the United States, but here, too, is a proviso that the legal reserve shall not be included as part of the cash actually invested. Similar provisions are found in Section 100 of the Revenue Act of 1918, c. 18, 40 Stat. 1057.

So, too, the net additions required by law to be made within the year to reserve funds have been deductible from gross income, under Section 38 of the Corporation Excise Act of August 5, 1909 (c. 6, 36 Stat. 112); Section II, G (b), of the Revenue Act of October 3, 1913 (c. 16, 38 Stat. 114, 173); Section 12, Title I, of the Revenue Act of September 8, 1916 (c. 463, 39 Stat. 756, 768; as well as by the Revenue Act of 1917, which amended the Act of 1916, only by increasing the rate of tax.

The deduction of the net addition to the reserve funds required by law, allowed in all the Revenue Acts as a proper deduction from gross income, was a clear recognition of the fact that such portion of the premiums received as became part of the reserve of the year was no part of the net income to the company, for it was immediately balanced by a corresponding increase of liability.

That the legal reserve of a mutual life insurance company was not within the statutory definition of invested capital was the claim made by Mr. Rhodes, Vice President of the respondent company, before the Senate Subcommittee on Finance, when the excess-profits tax imposed by the Act of March 3, 1917, was under consideration.

We quote from Hearings before the Senate Subcommittee on Finance, 64th Congress, 2nd Session, on H. R. 20573 as follows, p. 48:

> Mr. RHODES. * * * I am trying to be conservative in my statements. Now, this bill says what? We do not know precisely

what, except that insurance companies are to be taxed under it the same as a commercial business; but we are not taxed the same as a commercial business. A commercial business can deduct from its taxable net income, as shown in its income tax return, 8 per cent of its actual capital invested, and it need pay no tax on that 8 per cent. But what can a mutual life insurance company deduct from its taxable net income? It has no actual cash paid in such as is referred to in section 202. It has no actual cash value at the time of payment of assets other than cash paid in. If, as I assume, that means the actual cash value of property other than cash represented by shares of stock, has it any paid-in or earned surplus and undivided profits which are used or employed in the business? We might possibly get 8 per cent of the amount that we are holding as a contingency reserve aside from this specific exemption of $5,000, and that is all that we could get if we get that.

Senator THOMAS. In your annual statements, do you not give figures showing what you call your surplus and also what you call your profits?

* * * * *

Mr. RHODES. That question of profits has a very essential bearing upon this matter. We have a contingency reserve or surplus—that is, over and above our required liabilities, the liabilities that the insurance departments of

several States require us to put up—of $9,682,000.

Senator THOMAS. That is your surplus?

Mr. RHODES. That is what you might call surplus. It is held to meet contingencies. There was a time when life insurance companies held large surpluses and those large surpluses were at times subjected to abuse. That has been done away with with the reforms that have been instituted in life insurance. Their surpluses to-day are limited by law. They can not hold them. That $9,682,000, gentlemen, of surplus that we hold is just about 1 per cent of our contingent liabilities. It is there to meet any contingency that arises. Every dollar of our income over and above that and what is used to pay our running expenses is returned to the policyholders.

And at page 52:

Mr. RHODES. If this bill should be amended, sir, so as to provide that before we were taxed we should deduct 8 per cent of our invested reserve, we would be on a par.

Senator SMITH. What is the language of the bill that you think reaches you?

Mr. RHODES. That section 200, "That when used in this title—the term 'corporation' includes joint stock companies or associations and insurance companies." Not stock insurance companies; all insurance companies.

Senator SMITH. I understand. Now, how does the language reach you even then?

How does it describe a net profit that you make?

Mr. RHODES. Under section 201 we have this language [reading]: "That in addition to the taxes under existing laws there shall be levied, assessed, collected and paid for each taxable year upon the net income of every corporation and partnership organized, authorized, or existing under the laws of the United States, or of any State, Territory, or district thereof, * * * a tax of eight per centum of the amount by which such net income exceeds the sum of (*a*) $5,000 and (*b*) eight per centum of the actual capital invested."

Section 202 further provides: "That for the purpose of this title, actual capital invested means (1) actual cash paid in," of which we have none; "(2) the actual cash value, at the time of payment, of assets other than cash paid in," of which we have none, if that means property represented by shares; "and (3) paid in or earned surplus and undivided profits used or employed in the business."

There is your definition of actual capital invested, which does not apply to a mutual insurance company.

(a) The opinion below

The fundamental error we have already referred to. With the conviction as a point of departure that Congress did not have in mind mutual life insurance companies, the Court tried to find an analogy between the capital, surplus and undivided

profits of ordinary stock corporations and the invested funds of a mutual life insurance company. In the first place, no search for analogies is called for, as the language of the statute is plain and the meaning of the terms used well understood. In the second place, the analogies found were based upon a misconception of the law and the facts; for instance, the court said (R. 34):

> These members—policyholders—are analogous to shareholders in a stock corporation. Subdivision (1), par. (a), of sec. 207 of the revenue act of 1917 is not expressly restricted to cash paid for shares of stock, and if mutual insurance companies are to be subjected to the imposition of war excess-profits taxes, then by analogy so much of the premium payments made by such members which is in excess of the actual cost of the insurance should be held to come within such subdivision and be treated as "invested capital."

This disregards what was said by this Court in *LaBelle Iron Works* v. *United States*, 256 U. S. 377, *supra*. It also misconceives the nature of so much of the premiums as "is in excess of the actual cost of the insurance." That portion of the premiums which becomes part of the reserve is necessary to cover the actual cost of the insurance. The portion which is in excess of the cost is returned, with the exception of such portion as is retained and accumulated in the interest of con-

servative safety as a surplus. It is that surplus which the Commissioner treated as invested capital.

Again, the court erred in drawing an analogy between the reserve and the surplus referred to in subdivision (3). The court, referring again to the premiums being intentionally made larger than necessary to defray cost, said (R. 35):

> Therefore, all that part of these premiums that is larger than necessary for cost insurance is, by analogy, paid in, either as capital or surplus, for the purpose of carrying on the insurance business in which the members are mutually engaged. As a part of these excess payments in premiums are carried into the legal reserve, at least so much of this reserve as represents redundant payments of premiums becomes capital or surplus and falls within subdivisions (1) or (3) or possibly both, and are as much "invested capital" as any cash paid for shares by shareholders of a stock corporation or earned or paid-in surplus used and employed by such corporation in its business.

Here, again, is repeated the error that the reserve is made up of redundant payment of premiums. The Court has confused the "net or mathematical" or actuarial premium, based upon experience tables and a given rate of return, with the premium charged the policyholder, which is the mathematical premium plus loading. (R. 3.) To be sure, the level premiums, which remain the same throughout

life, are greater in the early years than would be the "natural" premiums for those years, just as they are less during the later years. Level-premium insurance averages the premium over the entire period and in the early years builds a reserve to take care of the later years, but it is a misconception to say that the reserve represents a redundancy at any time. Every dollar of the reserve is, in contemplation of law, necessary to enable the company to perform its contract, and no part of it could be returned, waived, or otherwise disposed of without impairing the solvency of the company. The only redundancy is from excessive loading.

The court also was impressed by the seeming injustice which would result to a company which kept its premiums closest to the mathematical cost and did not accumulate a surplus. Such a company would pay a greater *pro rata* excess-profits tax than the company which charged high premiums and accumulated a large surplus. The same condition is true of commercial companies. Upon the same income a small surplus or invested capital results in a large excess-profits tax, while a large surplus or invested capital results in a small excess-profits tax. This was one of the obvious evils of the system. Its effect was to penalize conservative business. The answer, however, is that Congress passed the Act and it must be followed even though it produces, in individual cases, results which seem strange. That it was found to produce uneconomic

results was doubtless one of the reasons why Congress repealed it in 1921. The wisdom of the excess-profits tax is not a concern of the courts.

IV

The legislative history shows that Congress did not intend that the legal reserve should be included in invested capital

As a matter of fact, the inclusion of a provision allowing the legal reserve as a part of invested capital was urged upon Congress when the passage of the first Excess Profits Tax Act of March 3, 1917, was under consideration. See Hearings before the Senate Subcommittee on Finance, 64th Cong., 2d sess., on H. R. 20573, pages 45, 52, et seq.

It was again urged when the Revenue Act of October 3, 1917, was under consideration, and the following amendment was suggested:

> That title 2, section 202, of H. R. 4280, entitled "A bill to provide revenue to defray war expenses, and for other purposes," is hereby amended so as to read as follows:
>
> "SEC. 202. That for the purpose of this title actual capital invested means (1) actual cash paid in; (2) the actual cash value of property paid in other than cash, stock, or shares of such corporation or partnership at the time of such payment; and (3) paid-in or earned surplus and undivided profits used or employed in the business and *including the invested reserve funds of insurance com-*

> *panies.*" (Brief on behalf of Massachusetts Mutual Life Insurance Company. Hearings before the Senate Subcommittee on Finance, 65th Cong., 1st sess., on H. R. 4280, page 258.)

And again when the Revenue Act of 1918 was under consideration an amendment to include reserves as invested capital was submitted by Mr. Hedges, on behalf of the Association of Life Insurance Presidents, as follows:

> Therefore I submit to the wisdom of the committee that section 2, an amendment to the act of October 3, 1917: Section 207, paragraph A, subdivision A, after the words "paid in or earned surplus," that there shall be added these words: "including the reserves required by law to be accumulated and maintained by life insurance companies." (Hearings before the Committee on Ways and Means on the proposed Revenue Act of 1918, Part 1, page 800, and see also statement at bottom of page 811.)

The whole history of the profits tax shows that from its inception insurance companies have endeavored without success to have incorporated by express language a provision that the legal reserve shall be included as "invested capital." In each of three successive acts Congress refused to adopt the proposed amendment. There can be no doubt about what Congress intended.

CONCLUSION

For the reasons stated the judgment below should be reversed.

WILLIAM D. MITCHELL,
Solicitor General.
ALFRED ADAMS WHEAT,
Special Assistant to the Attorney General.
NEWTON K. FOX,
Special Attorney Bureau of Internal Revenue.
SEPTEMBER, 1926.

IN THE

Supreme Court of the United States

OCTOBER TERM, [redacted] 1925

CHARLES V. DUFFY, former Collector of Internal Revenue,
Petitioner,

vs.

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY,
Respondent.

ANSWER AND BRIEF OF RESPONDENT.

Arthur W. Orum, Law Printer, 30-32 Lafayette Street, Newark, N. J.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1924.

CHARLES V. DUFFY, former Collector of Internal Revenue, *Petitioner,* *vs.* THE MUTUAL BENEFIT LIFE INSURANCE COMPANY, *Respondent.*	*No.*

Answer and Brief of Respondent.

Statement of Case.

Respondent is a mutual life insurance company with no capital stock and no stockholders (Complaint, Record, pp. 2-3).

The page references are to the printed record used in the Circuit Court of Appeals.

All persons who insure with the company become members of the corporation. Its business is conducted by directors chosen by and from the members (Charter, Sec. 2; Record, p. 27).

Like practically all life insurance companies, respondent conducts its business on the level premium plan, whereby during the policy period that part of the premium to be paid annually to meet death losses is an average of the low natural premiums in the earlier years and the high natural premiums in the later years of life, thus avoiding the necessity of prohibitive premiums as the probability of dying increases with advancing years.

The average premium so estimated, increased by an allowance for cost of conducting the business, is uniform throughout the life of the policy. (Fully explained Complaint, Record, p. 3 bottom and p. 4 top; also in *Mutual Benefit Life Insurance Company* v. *Herold*, 198 Fed. 199, at 202 bottom.)

The sums in excess of the amount required to pay death losses (technically known as the cost of insurance) in the earlier years, augmented by interest, constitute a "reserve" which serves to maintain the insurance in the later years when the stipulated level premium would otherwise be insufficient to meet the current cost of insurance. This reserve is usually denominated the "legal" reserve because it is required by law.

At the end of each year the excess of income over death losses and other disbursements is ascertained, and after setting aside so much thereof as is required by law for the increase in the policy reserve, each policy-holder's share in the balance is ascertained and returned to him either in cash or by credit upon his next annual premium, as he may elect (Complaint, Record, p. 4).

The laws of all the states require of every life insurance company as a condition precedent to the continued transaction of business that its assets shall not be less than the legal reserve (Complaint, Record, pp. 4, 5).

The amount of legal reserve is calculated annually by the supervising commissioners and by the companies, and is based on an assumed rate of mortality formulated from long experience and an assumed rate of income from invested funds conservatively estimated at a low rate.

Theoretically, a life insurance company answers all the requirements of law and of sound practice if it maintains assets sufficient at the end of each year to equal the legal reserve then calculated.

Practically, however, conservative companies maintain assets somewhat in excess of the "legal" reserve, in order to meet contingencies, such as a fall in market value of securities, or an abnormal increase in mortality due to war and pestilence, both of which were experienced to an unusual degree in connection with the late war. This margin of safety in assets over reserve requirements respondent denominates its "contingency reserve." The amount of it is in the discretion of the directors, based on experience and forecast.

These two reserves—one required by law, the other discretionary—comprise the entire assets of the respondent, which are invested under statutory restrictions in government, municipal, railroad and utility bonds, bonds secured by mortgages on real estate, loans on collateral and to policy-holders, and a necessary office building. The average rate of interest on respondent's invested assets is, and for many years has been less than six per cent. per annum (Complaint, Record, p. 3).

Respondent's assets are not segregated or earmarked or specially allocated to either of these reserves. Nor are they separately invested. There is no requirement of law or sound practice that requires such allocation, nor is it practicable in view of the fluctuating market values of the assets, which would require a constant shifting of assets from the legal reserve to the contingency reserve and *vice versa*. The assets, therefore, constitute one general fund. The interest earned on all its securities except those which, because of their character, are specifically exempt from tax, is included in respondent's return of gross income for federal income tax purposes (Complaint, Record, p. 4, l. 31, to p. 5, l. 2).

On January 1, 1917, respondent's assets amounted to $198,713,925 (Record, p. 13) and its legal reserve was computed at $186,258,796. Of this latter sum about $70,000,000 consisted of premiums paid in by its policy-

holders, and about $116,000,000 consisted of interest earned by its invested funds (Complaint, Record, p. 6).

In 1909, Congress by the Corporation Excise Tax Law (36 Stat. 112, C. 6, Sec. 38, U. S. Comp. St. Supp. 1911, p. 946), imposed a tax on life insurance companies based upon their income. In its application to respondent, certain questions arose which were considered by the United States District Court for New Jersey in the case of *Mutual Benefit Life Insurance Company* v. *Herold, Collector,* 198 Fed. 199, affirmed by the Circuit Court of Appeals on the opinion below, 201 Fed. 918, and considered in this court on petition for writ of certiorari, 231 U. S. 755, the application being denied. In that case the opinion of the lower court set forth fully the principles of mutual life insurance as practiced by respondent and other similar insurance companies, the method of determining premiums and reserves and the return to policyholders of any excess payments, and ascertained that these methods were intended to and did result in furnishing insurance to policy-holders *at cost,* and cited with approval cases holding that gains and profits were foreign to the principles of mutual life insurance.

In the Corporation Excise Tax Law of 1909, the annual additions to the legal reserves of life insurance companies were excepted from taxable income, apparently because they were additions to capital assets contributed by the policy-holders either in their premiums or in the interest earnings therefrom. This principle has been continued in all the income tax laws enacted under the income tax amendment to the Constitution.

The "War Excess Profit Tax" Law.

After this country entered the World War, Congress on October 3, 1917, passed an act "to provide revenue to defray war expenses" and adopted the method pursued by the other belligerent countries of imposing a heavy

tax on those industries which were realizing unusual profits on account of war activities.

The purpose was clearly expressed in the Senate Finance Committee's report of August 6, 1917 (Calendar No. 106, Sixty-fifth Congress, First Session, Report No. 103, Senate, pp. 3 and 4) as follows:

> "After mature consideration your committee reached the conclusion that, in view of the large amount to be raised and the enormous war profits, amounting to nearly $3,000,000,000, shown by the income-tax returns of corporations for 1916, which amount will undoubtedly be increased for the year 1917, due in the main to war and war conditions, $562,000,000 was not an unreasonable additional amount to ask *from the industries whose earnings have been so greatly augmented by* the conditions which made necessary the call for this additional revenue.
>
> * * * * * *
>
> "Your committee accordingly proposes the repeal of the existing war-profits tax law, and the substitution for both it and the additional war-profits tax passed by the House of a tax upon a basis similar to that followed by the European countries in which such taxation has been carried out with marked success. The committee proposes, instead of an *excess*-profits tax, a *war*-profits tax. In general, it proposes to make the basis of the tax the difference between the profits of the pre-war period and the profits of the taxable year. We take by taxation, directly or indirectly, for the purposes of war, a part of the *extra gains which war itself has caused.*"

This purpose was attributed to the law by this court in *La Belle Iron Works* v. *U. S.*, 256 U. S. 377, at 386, as follows:

> "Reading the entire language of Section 207 in the light of the circumstances that surrounded the passage of the Act, we think its meaning as to 'invested capital' is entirely clear. The great war in Europe had been in progress since the year 1914,

> and the manufacture and export of war supplies and other material for the belligerent Powers had stimulated many lines of trade and business in this country, resulting in large profits as compared with the period before the war, and as compared with ordinary returns upon the capital embarked.
>
> "The United States had become directly involved in the conflict in the Spring of 1917, necessitating heavy increases in taxation; at the same time manufactures and trade of every description were rendered even more active, and in certain lines more profitable, than before, so that the unusual gains derived therefrom formed a natural subject for special taxation."

By that law, in addition to the ordinary income tax to which respondent and all other corporations had been subjected, a provision was added, specifically denominated a "war excess profits tax," as recommended by the Senate Committee.

To determine what were "war excess profits," Congress decided that a reasonable profit was between seven and nine per cent. of the invested capital, and for comparison with pre-war period of profit defined invested capital in the case of corporations as including "actual cash paid in" * * * and "paid in or earned surplus and undivided profits used or employed in the business," excluding assets exempt from the ordinary income tax, also borrowed money. The term "corporation" was defined (the same as in the general income tax law) as including "insurance companies."

There is abundant evidence in the scheme of the act that Congress had in mind only corporations organized for profit, and not mutual life insurance companies. However, as the latter were not expressly excepted, the revenue authorities required respondent, in addition to its return of ordinary taxable income for the year 1917, upon which it showed a net income of $1,800,000 and a tax of $108,500 (Complaint, Record, p. 8), to make a return

under the War Excess Profits Tax Law. In making its additional return for 1917, under the War Excess Profits Tax Law, and applying its provisions by analogy to a mutual company, respondent reported, as its invested capital, the total amount of "actual cash paid in" by its members (analogous to stockholders) and the interest that had been earned, as its "capital, surplus and undivided profits" at the beginning of the taxable year, amounting to $198,712,831, which, after deducting about $4,000,000 of tax-exempt securities as required by the act, and adding about $8,000,000 for increase of invested capital during the current year, made respondent's invested capital for the year in question $202,685,846 (Complaint, Schedule H, Record, p. 20). As respondent's taxable income for that year was $1,808,000, it did not approach the seven per cent. allowed by the act on invested capital, and the return showed no war excess profits tax due.

The Disputed Assessment.

Notwithstanding all the invested capital as so returned represented actual cash previously paid in by the members of the corporation, or accumulated earnings therefrom, the Commissioner of Internal Revenue, in an effort to subject respondent to a war excess profits tax, arbitrarily amended its return by deducting from its invested capital as returned, a sum equal to its legal reserve, leaving as its invested capital only the small residue of contingency reserve held by it as a margin of safety in support of its legal reserve. This deduction left only $14,719,000 as respondent's invested capital for the purpose of the act, or about seven per cent. of its earning assets. Allocating thereto all of the taxable income of $1,800,000 earned by all of the $200,000,000 of respondent's assets, the apparent income on such artifically determined invested capital was necessarily in excess of the maximum of nine per cent. permitted by the act, and on that basis respond-

ent was subject to a war excess profits tax of $83,779.70 for the year 1917, which on June 10, 1920, the Commissioner assessed against the respondent (Complaint, Record, p. 8).

Thus, by a stroke of the pen, the plaintiff—a benevolent institution engaged exclusively in the business of furnishing to its members life insurance at cost, with no purpose or opportunity to make gains or profits of any kind, but necessarily subjected by the war to unusual losses—was transformed into a "war profiteer" and condemned to pay $83,000 in addition to the $108,000 it had paid as ordinary income tax.

Natural Construction of the Act.

This deduction of respondent's legal reserve from its invested capital seemed unjustifiable. In the *La Belle Iron Works* case, this court held that the purpose of Congress in its definition of invested capital for the purpose of the act was to determine such capital on the basis of *cash* contributed or accumulated, as distinguished from estimated values of earning capital (256 U. S., p. 387), thus avoiding confusing questions that would naturally arise and "guarding against inflated valuations."

It seemed equally evident that Congress by the "non-inclusion clause" (Sec. 207, par. 2) intended merely to co-ordinate the "excess profits tax" with the ordinary income tax and limit the capital on which the new act was based to invested assets that yielded income taxable under the main act. To accomplish that purpose it was logical and necessary to deduct from invested capital "assets, the income from which is not subject to the tax imposed by this title," and likewise borrowed money the interest on which is deducted from gross income in determining the net taxable income.

This is the natural construction of the clause, and it bears no suggestion or implication that it was intended to exclude from capital account income-producing assets of the plaintiff constituting its legal reserve, other than its tax-exempt bonds. These were deducted in plaintiff's original return.

There is nothing in the scheme of the act to indicate that Congress intended any other definition of capital than what is implied in the statement in *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, at 518:

> "Income may be defined as the gain derived from capital, from labor, or from both combined."

Conversely, in non-industrial companies, capital is that from which income is derived. The only limitation upon that definition intended by Congress in the two clauses in question is that for the purpose of the act capital is valued on a *cash* basis, and assets that yield non-taxable income are deducted.

Respondent therefore paid the additional assessment under protest and immediately began suit to recover the amount so paid. This suit resulted in a judgment in the respondent's favor entered February 26, 1924 (Record, p. 68), which was later affirmed by the United States Circuit Court of Appeals for the Third Circuit on March 2, 1925. For opinion in District Court, see 295 Fed. Rep. 881, on appeal, 3 Fed. Rep. 2d series, p. 1020.

In the District Court the Commissioner sought to justify the deduction of the amount of the legal reserve by what respondent claimed and claims is a strained, artificial and technical construction of the war excess profits tax law (quoted in the opinion of the District Court, Record, pp. 47-51).

Argument.

I.

The legal reserve is within the statutory definition of invested capital as "actual cash paid in" and "paid in or earned surplus."

This is disputed by petitioner's brief, Points I and II.

His contentions were fully met by the District Court in its opinion (Record, pp. 58-61).

The petitioner's case is based on the assumption that in Section 207 (a) (1) the words "actual cash paid in" are qualified by the words in paragraph (2) "for stock or shares." To support this he quotes from the *La Belle Iron Works* case the following words:

> "Cash paid in, and tangible property paid in other than cash are confined to such as were contributed for stock or shares in the corporation."

As that case concerned a stock corporation this was a correct paraphrase of the statute as applied to that case. There was nothing in the case calling for a construction of the act as applied to a mutual company without capital stock, and it can not be assumed that this court intended to give the words that construction when applied to a mutual company. The District Court took this view (Opinion, Record, p. 60, l. 31).

Petitioner further relied for that construction on the fact that on a later revision of the act in question subdivision (1) was amended to read "actual cash bona fide paid in for stock or shares." The fact that Congress made that revision is its own admission that the words of the prior act did not carry the implication claimed by the petitioner. The District Court took this view (Opinion, Record, p. 61, l. 3).

If the words "actual cash paid in" are by construction to be qualified by the words "for stock or shares" one

of two alternatives must be selected. Either (a) the act does not apply to mutual companies without capital stock; or (b) the word "shares" must be construed as referring to each policy-holder's interest as a member in the assets of the corporation (Opinion, Record, p. 60, l. 29).

Under the latter alternative the actual cash contributions of policy-holders to the company's assets, $70,000,000 (Record, p. 61, l. 9), would be the "actual cash paid in for shares." The remainder of the reserve, representing interest earnings, $116,000,000. would, on the Court's construction, be earned surplus. As Judge Rellstab pointed out (Record, p. 62, ll. 20-30), if the $70,000,000 of the legal reserve paid in in cash by the policy-holders was not paid in as capital it must be considered as paid-in surplus. Either of these sums credited as either paid-in capital or paid-in or earned surplus is sufficient to relieve the company of the tax assessed. The complaint (p. 8) avers that "if on any computation, plaintiff's invested capital had been ascertained at a sum in excess of $25,500,000, no war excess profits tax would have been due." As the decision in the District Court was on a motion to strike out the complaint, all averments are taken as true.

II.

The legal reserve is not such a liability as requires that it be deducted from invested capital.

The petitioner's claim to the contrary is covered under Point III of his brief (p. 10) and was disposed of by the Court in its opinion (Record, p. 47, ll. 15-20).

Petitioner's statement of the proposition involves a confusion of terms. "Assets" and "Liabilities" are not alternative terms but correlative. When stockholders pay in capital to a corporation the cash becomes "Assets" and is entered on that side of the statement. A correspond-

ing entry of capital stock is made on the other side of the statement under "Liabilities." Accumulated and undistributed earnings are entered on the "Assets" side of the account either as plant, goods or investments, and at the same time are entered on the opposite side of the account under "Liabilities" as "surplus" accruing to stockholders in addition to their item of capital stock.

So, in a mutual life insurance company, so much of the policy-holders' premiums that are reserved under the level premium system become assets and are invested and entered on the "Assets" side of the account as investments. They are also entered on the "Liabilities" side as "legal reserve." The additions thereto from interest earnings are likewise entered on the "Assets" side and on the "Liabilities" side as an addition to the legal reserve. The balance sheet therefore on the "Assets" side will show the investments, and on the "Liabilities" side the legal reserve and any additional funds retained for contingencies—in respondent's case, called contingency reserve.

By analogy to a stock corporation the legal reserve of a mutual life insurance company represents the interest of the members in the assets of the company in the same way that the capital stock and surplus of a stock corporation represent the stockholders' interests in the assets of the corporation.

The fact that in annual reports of life insurance companies the legal reserve is carried on the "Liabilities" side of the balance sheet means nothing more than above stated and does not change its character.

So long as a member lives and continues his policy his status is analogous to that of a stockholder. Like a stockholder in a building and loan association, he has a right to withdraw by discontinuing his premium payments and may then have a share of the reserve, but not before.

On a policy-holder's death his policy contract with his associates becomes a claim for a definite amount and is then for the first time converted into a debt. Until his death his interest is not that of a debtor but of a shareholder.

The foregoing outline of the relations between a policyholder and a mutual life insurance company and its assets is fully discussed and defined in an authoritative decision of the Court of Errors and Appeals of New Jersey in *Mayer* v. *Attorney General*, 32 N. J. Eq. 815.

If the insurance company becomes insolvent his interest in its assets after payment of its debts, including the policy claims of those who have previously died, becomes an ascertained claim against the receiver which may be offset against any money he owes the company by way of mortgage or otherwise. This was all that was held in *Carr* v. *Hamilton*, 129 U. S. 252.

New Jersey and some other states by statute tax life insurance companies only on the excess of their assets over their legal reserves. This is not because the reserve is a debt, but is a special statutory concession to life insurance companies to avoid oppressive and perhaps destructive taxation, for it is clear that if all of the assets of a life insurance company were taxed annually for local purposes at current rates (now four per cent.), it would absorb nearly all their interest income and disappoint the assumption on which their unchangeable premiums are based.

This legislative purpose is clearly expressed in the case cited by petitioner, *Mayor of Newark* v. *Board of Equalization*, 80 N. J. L. 258; 81 *Id.* 416, at p. 421:

> "The right given by the statute, to the company, to deduct from the amount or value of its property the amount of its liability on its policies, is, in its essence *a grant of exemption from taxation.*"

Also, in *People's Fire Insurance Company* v. *Parker*, 35 N. J. L. 575, where the Court said (p. 579):

> "The act of March 24, 1864, which relates to corporations whose business is that of insurance on lives is a peculiar statute for a favored class and the allowance of deductions for the present value of policies as a part of the liabilities of such companies * * * is certainly an exception from the general policy of the statute in taxing private corporations."

Cases on similar statutes in other states will be found to be based on the same ground, namely, a considerate indulgence to life insurance companies which would otherwise be subjected to destructive local taxation.

This legislative concession in favor of life insurance companies from the ordinary policy of statutory taxation does not justify the conclusion that the reserve is a debt that should be deducted from their invested capital in the application of the War Excess Profits Tax Law and thereby subject these companies to injurious if not destructive taxation by the Federal agencies.

It was admitted upon both arguments that fire insurance companies were in fact permitted to include their reserve funds in their invested capital. The result was that such companies, which are in business for profit, were relieved to that extent of the Excess Profits Tax, while life insurance companies, which can make no profit, were penalized by having their legal reserves deducted from their invested capital and thereby subjected to a War Excess Profits Tax.

The Commissioner's ruling was expressed in Treasury Decision No. 3153, Article 870, Regulations 45, thus:

> "The reserve funds of life insurance companies * * * can not be included in computing invested capital. The like reserve funds of insurance companies other than life insurance companies may be included in computing invested capital."

Another distinction was overlooked by the Commissioner, namely, that the reserves of fire insurance companies represent the measure of their obligations on contracts of insurance with *third parties* while in life insurance companies the legal reserve measures the interest therein of *members* of the corporation.

In further support of his claim that the legal reserve should be deducted from invested capital, petitioner (Brief, p. 9, top) asserts that the reserve is a trust fund belonging to the policy-holders.

This claim was readily disposed of by the District Court in its opinion (Record, p. 47).

There can be no doubt that the assets belong to the company. The imposition of an income tax on the company concedes that.

Nor would denomination of the legal reserve as a trust fund change its character as comprising assets constituting respondent's earning capital, whose income was subject to the ordinary income tax. The trust fund doctrine may have just application to equitable relationships, but it has never been invoked to change the ownership of corporate assets for purposes of taxation.

Whether the legal reserve be denominated a trust fund or a liability should make no difference in the decision of this case, as the contingency reserve has the same source, and is held for the same purpose, namely, to enable respondent to carry on its business of fulfilling its policy contracts. They combine to form the basis of the income that is subject to income tax. As the Court pointed out (at p. 60), the attempted segregation of the two reserve funds is unsubstantial and illogical. If one is not invested capital, neither is the other.

III.

Congressional Intent.

Petitioner seeks to infer a Congressional intent that the legal reserve should be excluded from invested capital, and this on three grounds.

First. Discussions before Congressional sub-committees.

Petitioner, at page 13, cites some hearings before Congressional sub-committees in which representatives of life insurance companies expressed their fear that the Commissioner might make an unreasonable construction of the proposed tax law. Judge Rellstab thoroughly considered these discussions and held they could have no effect upon the construction of the act in question (Opinion, Record, p. 64, l. 29, to p. 67, l. 7). His review of the testimony shows that the sub-committee evidently thought the fears were groundless.

It is interesting to note that Congress, by Sec. 243 of the Act of November 23, 1921, 42 Statutes at Large, Ch. 136, p. 261 (the first revision of the act after this tax was imposed) retroactively relieved life insurance companies of the War Excess Profits Tax for that year while retaining it for all other corporations, including fire insurance companies. This strongly implies disapproval of the Commissioner's interpretation.

Second. The exclusion of the legal reserve of life insurance companies from the capital stock tax on surplus and undivided profits imposed by Sec. 407 of the Revenue Act of 1916 (Petitioner's brief, p. 15).

This does not justify the inference that Congress meant to exclude these reserves in another act based on a different principle and for another purpose.

This distinction was clearly pointed out in the Treasury Regulations 64 of June 15, 1922 (Art. 15):

"The fair value of the capital stock, as provided under section 1000 (a) (1) of the Revenue Act of 1921, and invested capital under the excess profits tax provisions of the Revenue Act of 1921 are not necessarily the same.

"For the purpose of capital stock tax the fair value of the capital stock is estimated, and is predicated on present values, including actual appreciation of property, whether realized or unrealized, and such intangible assets as good will, trade-marks, and patents to the extent reflected by the earning power, whereas, for the purpose of excess-profits tax, the invested capital is based upon the actual investment of the stockholders in the corporation, irrespective of the present value of its assets. In the case of the capital-stock tax the fair value looks to the present net value of the assets, irrespective of the amount of the investment of the stockholders."

In the next place, the Capital Stock Tax Act, in determining the value of the capital for the purpose of that act, expressly excluded the reserves of both fire and life insurance companies. The inference from this express exclusion is that Congress assumed that otherwise the reserves of both fire and life insurance companies would be included as capital for the purposes of the Capital Stock Tax Act.

If Congress had intended to exclude the legal reserve of life insurance companies from invested capital under the War Excess Profits Tax, the inference is strong that it would have made a similar provision of exclusion in that act. The fact that it did not shows an intent to have it counted as invested capital.

Third. That the net addition to legal reserve is not subject to ordinary income tax, and that therefore the reserve was within the non-inclusion paragraph of Sec. 207 of the War Excess Profits Tax Law.

To this claim respondent answered in the courts below that the terms of the non-inclusion paragraph were intended to define the *character* of the *assets*, and not the liabilities in the balance sheet, and referred to those classes of assets the income from which was exempt from the ordinary income tax, such as stocks and tax-exempt bonds, an exception, however, being made in favor of the obligations of the United States apparently for the purpose of encouraging their purchase by corporations engaged in war industries.

In further answer, respondent pointed out that the deduction from gross income, in the year when made, of the addition to the legal reserve, indicated conclusively that Congress considered them as contributions to the capital of the corporation, particularly as the income derived therefrom would be taxed in the following years.

Respondent further claimed that if more than the current annual addition to the reserve was held to be assets not subject to tax, this would not extend to so much of the legal reserve as had been accumulated before any income tax was imposed on corporations by Congress.

Respondent's views as so outlined were sustained by the District Court, upon very thorough and careful consideration (Record, pp. 51-58). (It should be noted that in the Record, at the middle of page 56, the second word of the paragraph, "pay," is a misprint for the word "tax" used in the opinion; also that in the sixth line of page 58, the words "other than bonds" should be "and other bonds.")

The Court further demonstrated (Record, p. 62 bottom, to 63 bottom) that prior to 1909, and before the government imposed an income tax on corporations, and even before it imposed an excise tax based on annual income, respondent had accumulated a legal reserve of over $110,000,000, or more than four times the sum of $25,500,-

000, to which its invested capital would have to be reduced in order to subject it, on any construction of the act, to a war excess profits tax (Complaint, Record, p. 8, ll. 13-16); and further (on p. 64) the Court demonstrated, from Schedule "F" attached to the complaint (Record, p. 18, l. 25), that of the legal reserve held by respondent January 1, 1909, the sum of $33,569,887 had been contributed directly by policy-holders in the form of premiums.

It was thus determined that under the most favorable construction that could be claimed by the Commissioner of the non-inclusion paragraph, when applied to the respondent's financial history, no War Excess Profits Tax could be justified.

The petitioner avers, without proof, that this suit involves $25,000,000. If so, it must be that a great many life insurance companies with a smaller proportionate contingency reserve than respondent are consequently taxable at a much higher rate, as pointed out by the Court (Opinion, Record, p. 60), and so will feel much more heavily than the respondent the injustice of the Commissioner's interpretation of the act.

If respondent's contingency reserve for 1917 had happened to be $1,000,000 instead of $14,000,000, then, under the Commissioner's interpretation, respondent's war excess profits tax would have been $948,000 instead of $83,000.

Respondent therefore respectfully submits that the statute in question should not by an artificial construction be extended to cover respondent and similar companies evidently not included within its purpose and spirit, but rather the words of the statute should be given their natural signification.

Respondent company began business in 1845, with no capital or assets. On January 1, 1917, it had $198,000,000. Where did it come from if it was not paid in or earned?

We respectfully submit that the law should not be so construed as to exclude from respondent's invested capital more than ninety per cent. of its income-earning assets.

The judgment of the Circuit Court of Appeals, unanimously sustaining the judgment of the District Court. "that the legal reserve fund was invested capital within the meaning of the act" should not be disturbed, and the application for certiorari should be denied.

JOHN O. H. PITNEY,
Counsel for Respondent.

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IN THE

Supreme Court of the United States,

OCTOBER TERM, 1926.

No. 108.

CHARLES V. DUFFY, Former Collector of Internal Revenue,

Petitioner,

against

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR RESPONDENT.

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IN THE

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No. 108

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR RESPONDENT.

Statement.

The judgment in the District Court was rendered on motion to strike out the amended complaint and upon a stipulation that the decision on that motion should finally dispose of the controversy (R. 38, 39). The allegations of the complaint must be taken as admitted.

We may direct attention to certain facts not brought out, or not emphasized, in the Government's statement of the case.

The respondent, being a purely mutual company, its policyholders constitute its members and are so described in the Company's charter (R. 2, 14). The contributions by its members since its organization, the amount returned to them, the expenses of management, and interest and other earnings are shown in Schedule A annexed to the complaint (R. 7). From this it appears that the actual cash paid in by the members of the corporation from the date of its organization to December 31, 1916, was $515,941,896.66, and the balance remaining and used in its business during the year beginning January 1, 1917 (the year in question here) was $198,712,831.17 (R. 7).

The respondent's assets are invested in its office building, and in government, municipal, railroad and utility bonds, bonds secured by mortgages on real estate, and loans to policyholders on collateral, and in foreclosed real estate as shown in Schedule B annexed to the complaint (R. 2, 7).

The average rate of interest or return on the respondent's invested assets is and for many years has been less than six per cent. per annum. None of its assets during the year 1917 yielded an income in excess of six per cent. A tabulation of the interest received in 1917 is annexed to the complaint as Schedule C (R. 2, 8).

In the respondent's management of its assets there is no segregation or special allocation of any part. They constitute one general fund. The reserve is not earmarked or separately invested (R. 3).

The net addition made each year to the respondent's reserve from the date of its incorporation to December 31, 1917, the minimum part that was derived from premiums, and the maximum derived each year from interest, with the

total reserve at the end of the year is set forth in Schedule F annexed to the complaint (R. 10).

From this it appears that of the respondent's reserve on January 1, 1917 ($186,258,796), not less than $70,302,157.10 consisted of premiums paid in by its policyholders, and not more than $115,956,638.90 consisted of interest earned on the investment of its reserve. Respondent's reserve on January 1, 1918 was $200,815,927, of which not less than $78,638,717.11 consisted of premiums paid in by its policyholders and not more than $122,177,209.89 consisted of interest earned on the investment of its reserve (R. 4, 10).

The net addition to respondent's reserve during the year 1917 was $14,557,131. Of this sum $6,220,570 arose from interest received in 1917 on assets held at the beginning of the year and $8,336,560 arose from premiums received during the year (R. 10). The interest received by the respondent in 1917 amounted to $10,130,857 (R. 8), of which only 61.402 per cent. or $6,220,570 was required for the addition to the reserve in 1917 (R. 10).

It was conceded that the respondent was entitled to have certain of its assets treated as invested capital (R. 5). But the Government, ignoring the total amount that was actually held for investment and which produced the income on which the tax was laid, to wit $198,712,831.17 (or with certain adjustments by way of additions made by the Government, $201,486,566.50 (R. Schedule H, preceding p. 11)), fixed the invested capital at only $14,719,043.76 (R. 5). This reduction left respondent's "invested capital" for the purpose of the Act at about seven per cent. of its earning assets. Allocating to this reduced amount all of the taxable income of about $1,800,000 earned by all of respondent's actual investment, the apparent income on such artificially

determined invested capital was necessarily in excess of the maximum of nine per cent. permitted by the Act and on that basis the Government computed a war excess profits tax of $83,779.70. Thus the respondent, a mutual life insurance company engaged in the endeavor to furnish to its members insurance at cost, and actually making less than six per cent. on its investment in the business, was transformed into a "war profiteer".

Manifestly, on this theory, the smaller the amount that a mutual life insurance company had accumulated over and above the assets which were equal to the "reserve" the larger the excess profits tax would be. The "invested capital" being thus reduced, the income of the Company derived from its investment would still remain large, and would relatively be so much larger that the income might easily come to 70 or 80 per cent. of the so-called "invested capital" bringing the Company into the highest brackets (up to 60 per cent.) of the tax intended as a tax upon undue war profits.

Further, it is conceded that if on any computation respondent's invested capital had been ascertained at a sum in excess of $25,500,000 no war excess profits tax would have been due. (This is owing to the statutory deduction of seven per cent. on invested capital). As the Government allowed to the plaintiff as "invested capital" the sum of $14,719,-043.76, if even approximately $10,000,000 of the assets held in reserve can be deemed to constitute invested capital, there would be no basis for the tax.

Opinion of the District Court.

The grounds of the decision in the District Court are succinctly shown in the following extracts from Judge Rellstab's opinion:

> "The government contends that the legal reserve of a mutual insurance company cannot be its invested capital, because it does not belong to it, but to the policy holders; that such fund is in the nature of a trust fund, and is in fact a liability, and not an asset. For some purposes this reserve is a liability, or a trust fund; but so is the capital subscribed by shareholders in a stock corporation. Both are treated as a liability in balancing assets and liabilities. In the case of an insolvent stock corporation, its assets are charged with a trust in favor of creditors. On the dissolution or liquidation of a stock corporation, the capital remaining after the payment of debts belongs to the shareholders. So, on the dissolution of a mutual insurance company, the holders of unmatured policies, after the payment of matured policies, share pro rata the assets of the company, including the legal reserve. Mayer *v.* Attorney General, 32 N. J. Eq. 815, 822. If the legal reserve of a mutual life insurance company is a liability or trust fund in favor of the policy holders, as the government contends, so are the other assets of the company. The difference between them is merely that the former is required by law to be maintained intact as a guaranty for the payment of such policies, and cannot lawfully be diverted to other uses" (R. 25-26).

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"An examination of the returns made by the plaintiff for the years 1911 to 1917, inclusive, for federal income tax purposes, discloses that while both its gross income and expenditures steadily increased, the increases were quite conservative, the average increase from 1913 being less than 7 per cent. The return for 1918, on the contrary, shows that, while the gross income increased at about the same rate, the increase in expenses over 1917 exceeded 12 per cent. While the end of military operations in 1918 necessarily limited the scope of the comparison for this purpose, yet even this short period confirms the concept that a life insurance company is more likely to lose than gain during a war period—more likely to have excessive losses than excessive profits. None of the plaintiff's assets during 1917 yielded a greater income than 6 per centum per annum, and the average rate of interest or return on its invested assets for many years was less than that percentage" (R. 29).

* * * * * *

"In amending the plaintiff's excess profits tax return, the Commissioner, applying section 203 (a), above, allowed only $9,657,529.56 as its average invested capital for the pre-war period, and calculated its average taxable income for such period at $869,678.46 or 9.005 per cent. In computing this average he refused to allow any of the legal reserve as part of the invested capital for the pre-war period, and in fixing such capital for the year 1917 he, of course, adhered to the same ruling, with the result that, as before stated, the invested capital for that year, as computed by him, was reduced from $202,685,846.45 to the sum of $14,719,043.76. This sum is less than $5,000,000 more than the total income received from the actual invested assets for that year; such income

equaling 67.42 per cent. of the amount allowed as invested capital. As noted, so much of this reserve as was not interest from invested assets was obtained from the members of the corporation—policy holders—in the shape of premiums. These premiums were deliberately made larger to permit of a part being applied to the legal reserve. By such contribution the plaintiff's only capital fund was created and maintained. Without such redundancy of premiums the plaintiff could not have either complied with the statute requiring such reserve, or produced the nearly $10,000,000 interest which swelled the income on which it paid a federal income tax.

"To tax the income derived largely from an invested fund and deny that the fund is invested capital is neither logical nor consistent, and such a result should not be allowed, unless the statutory definition permits of no other course. This the government does not dispute" (R. 31).

* * * * * *

"The government concedes that all the plaintiff's assets, over and above the legal reserve, are invested capital within the meaning of such section, and the Commissioner's determination that the plaintiff had $14,719,043.76 as invested capital is based on such concession. It insists, however, that this sum embraces all the assets of plaintiff that fit in with the terms of subdivision (3), par. (a), of that section, and that that is the only subdivision which could be made applicable to such company.

"To my mind, the Commissioner's segregation of the plaintiff's assets into legal reserve and surplus is unsubstantial, and his determination that only the surplus constitutes the statutory 'invested capital' is erroneous. Such a ruling, as pointed out by the plaintiff, would produce strange results. The

company which kept its premiums closest to the mathematical computation of cost would have the smallest surplus—Commissioner's invested capital—the largest earnings pro rata, and pay the largest excess profits tax, while the company which secured the largest surplus through a liberal loading of the premiums would obtain the smallest earnings pro rata and pay the smallest excess profits tax. In the absence of compelling reasons, such an incongruous and inequitable result is not to be imputed to Congress. I fail to see how this so-called surplus of the plaintiff's assets may be held to be invested capital, as paid-in or earned surplus or undivided profits used or employed in the business, if the legal reserve is not. True, the legal reserve is required by law, while the other assets are not so required, and the company has less control over the disposition of the legal reserve than over its remaining assets. But these facts furnish no basis for excluding the former from, and including the latter in, 'invested capital.' Both have a common source, namely, premiums paid in by the policy holders and income derived from investments. So much of each of these classes of assets as represents premiums, is actual cash paid in to the insurance company by its members. These members—policy holders—are analogous to shareholders in a stock corporation. Subdivision (1), par. (a), of section 207 of the Revenue Act of 1917 is not expressly restricted to cash paid for shares of stock, and if mutual insurance companies are to be subjected to the imposition of war excess profits taxes, then by analogy so much of the premium payments made by such members, which is in excess of the actual cost of the insurance, should be held to come within such subdivision and be treated as 'invested capital' " (R. 33-34).

• • • • • •

"The individual premiums paid by a policy holder of a mutual life insurance company, as already stated, being intentionally made larger in amount than supposed to be necessary to defray the actual cost of insurance, it follows that they cover more than protection. Included therein is something for investment, differing radically in this respect from premiums paid for fire, marine or casualty insurance. Penn Mutual Co. *v.* Lederer, 252 U. S. 523, 533, 534, 40 Sup. Ct. 397, 64 L. Ed. 698. This portion paid as investment is retained by the company, and so much thereof as is added to legal reserve so continues until the policy matures or is surrendered. No dividends are paid out of this reserve during the continuance of the life of the policy, for it is kept invested and reinvested to mature the outstanding policies. It, as well as its increment, inures to the benefit of the policy holders, and this reserve, at all times while in the possession of the company, is capital invested or held for investment" (R. 35).

Opinion of the Circuit Court of Appeals.

The Circuit Court of Appeals affirmed upon the opinion of Judge Rellstab (3 Fed. (2d) 1020).

Summary of Argument.

First. The assets of a mutual life insurance company owned and held for investment in the business, as well as for protection, which are in fact invested capital, are not excluded by the statute from being treated as such.

Second. The legal reserve of a mutual life insurance company consists of assets contributed by the members of the corporation for investment as well as protection, to-

gether with assets earned on such investment and reinvested. These assets, invested in the business and forming the basis of the enterprise, are in fact, and under the statute, invested capital. The reserve is not an indebtedness.

(1) The title to the assets which are equal to, or are said to compose, the legal reserve is in the corporation.

(2) The legal reserve is not "money or other property borrowed."

(3) The fact that the reserve in question is required by law does not alter the quality of the assets which compose it.

(4) The legal reserve is not an indebtedness.

(5) The fact that several States, including New Jersey, tax life insurance companies only on the excess of their assets over their legal reserves does not make these reserves an indebtedness.

(6) The legal reserve is not a trust fund.

Third. The assets equal to, or composing, the legal reserve are not within the non-inclusion clause of the statute.

Fourth. The Government's claim is not aided by the capital stock tax act of 1916, but, on the contrary, the provisions and policy of that act support the respondent's contention.

Fifth. There is no distinction, in respect to the question here involved, between the reserve of a life insurance company and that of a fire, marine or casualty company.

Sixth. Statements made in the course of hearings before the Committees of Congress are immaterial.

ARGUMENT.

FIRST. The assets of a mutual life insurance company owned and held for investment in the business, as well as for protection, which are in fact invested capital, are not excluded by the statute from being treated as such.

The tax was laid under the provisions of Title II of the Act of October 3, 1917, imposing an excess profits tax (R. 5). The declared policy of this Act was to reach excessive profits made during the war. The Finance Committee of the Senate reported (Report of August 6, 1917, 65th Cong. 1st Sess., Sen. Rep. No. 103, pp. 3 and 4):

> "After mature consideration your committee reached the conclusion that, in view of the large amount to be raised and the enormous war profits, amounting to nearly $3,000,000,000, shown by the income-tax returns of corporations for 1916, which amount will undoubtedly be increased for the year 1917, due in the main to war and war conditions, $562,000,000 was not an unreasonable additional amount to ask *from the industries whose earnings have been so greatly augmented* by the conditions which made necessary the call for this additional revenue.
>
> • • • • • •
>
> "Your committee accordingly proposes the repeal of the existing war-profits tax law, and the substitution for both it and the additional war-profits tax passed by the House of a tax upon a basis similar to that followed by the European countries in which such taxation has been carried out with marked

> success. The committee proposes, instead of an *excess*-profits tax, a *war*-profits tax. In general, it proposes to make the basis of the tax the difference between the profits of the pre-war period and the profits of the taxable year. We take by taxation, directly or indirectly, for the purposes of war, a part of the *extra gains which war itself has caused.*" (Italics ours).

This purpose was attributed to the law by this Court in *La Belle Iron Works* v. *U. S.*, 256 U. S. 377, 386, as follows:

> "Reading the entire language of Section 207 in the light of the circumstances that surrounded the passage of the Act, we think its meaning as to 'invested capital' is entirely clear. The great war in Europe had been in progress since the year 1914, and the manufacture and export of war supplies and other material for the belligerent powers had stimulated many lines of trade and business in this country, resulting in large profits as compared with the period before the war, and as compared with ordinary returns upon the capital embarked. The United States had become directly involved in the conflict in the Spring of 1917, necessitating heavy increases in taxation; at the same time manufactures and trade of every description were rendered even more active, and in certain lines more profitable, than before, *so that the unusual gains derived therefrom formed a natural subject for special taxation.*" (Italics ours.)

It was necessary, however, in order to impose the desired tax on "excess profits" due to war conditions, to provide for a calculation of pre-war profits, and to exempt

what was deemed to be a fair equivalent. Such a calculation could not be made without taking into account the rate of return on the amount invested in the business, that is, invested capital. The foundation of the tax was not profits *per se*, but profits in relation to capital, and excess profits in the light of this relation. It was plainly in pursuance of this policy that the Congress defined invested capital. The definition of invested capital was not intended to be artificial or arbitrary but to allow what could reasonably be considered as the amount invested in the business.

The Government concedes that the respondent had "invested capital". The question is not whether a mutual life insurance company (without capital stock) can have "invested capital" under the statute, but of the way in which it should be computed. The Government assessed the tax in question upon the basis that the plaintiff *had* "invested capital", but computed this capital at only $14,719,043.76 (R. 5), ignoring other assets of the plaintiff actually held for investment and which produced the income upon which the tax was laid.

The Government, then, is not in a position to contend that a mutual life insurance company is outside the policy of the definition of invested capital in Section 207 of the Act of October 3, 1917. If a mutual life insurance company, without capital stock, is within the provisions of this act, as the Government insists, it is equally within the clear policy of these provisions and is entitled to have its actual invested capital taken into consideration in considering what, if any, excess profits it had made.

The Government seeks to limit the application of Section 207 to mutual life insurance companies by insisting that the only invested capital they can have must come

under subdivision (3) of Section 207(a) which relates to "surplus and undivided profits".

In this way, the Government reduced the amount of invested capital owned and held at the beginning of the tax year, from $198,712,831.17 to $14,719,043.76. The Government, in effect, says that a mutual life insurance company can have undivided profits as "invested capital" (this being the theory upon which the tax was laid) but cannot have as "invested capital" that which has been contributed by the members of the corporation for the purpose of investment and which earns the profits.

The Government gets under way with its argument by summarily eliminating, with barely more than the mere statement (Govt's. Brief, pp. 14, 15), subdivisions (1) and (2) of Section 207 (a). The Government asserts that these subdivisions apply only to payments for capital stock and that as a mutual life insurance company has no capital stock, it can have no "invested capital" under subdivision (1) which expressly allows as invested capital "actual cash paid in".

This presents the first question. We shall consider later the status of the assets called the "legal reserve". The preliminary question is whether a corporation without capital stock can have "invested capital" consisting of "actual cash paid in" within the meaning of subdivision (1) of Section 207 (a). The Government asserts that it cannot. We submit that the Government's construction is inadmissible and would do violence to the terms and clear intent of the statute.

The Government bases its assertion on what was said by this Court in *La Belle Iron Works* v. *United States*,

supra, p. 388. But there the Court was dealing with a stock corporation. It did not have the present question before it and manifestly the Court was not attempting to make an exclusive statement, but a statement applicable to the case it was deciding.

The Government apparently overlooks the fact that the sections of the Act of October 3, 1917 relating to the excess profits tax, applied not simply to corporations but also to *partnerships and individuals.* The Congress allowed as a deduction a certain return "equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period was of the invested capital for the prewar period (but not less than seven or more than nine per centum of the invested capital for the taxable year)" (Sec. 203). For this purpose the Congress defined invested capital in Section 207 as follows:

> "Sec. 207. That as used in this title, the term 'invested capital' for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.
>
> "As used in this title 'invested capital' does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title, nor money or other property borrowed, and means, subject to the above limitations:
>
> "(a) In the case of a *corporation or partnership*: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first,

nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year * * * .

"(b) In the case of an *individual,* (1) actual cash paid into the trade or business, and (2) the actual cash value of tangible property paid into the trade or business, other than cash, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen), and (3) the actual cash value of patents, copyrights, good will, trade-marks, trade brands, franchises, or other intangible property, paid into the trade or business, at the time of such payment, if payment was made therefor specifically as such in cash or tangible property, not to exceed the actual cash or actual cash value of the tangible property *bona fide* paid therefor at the time of such payment * * *" (italics ours).

It would seem to be clear that the Congress, while it prescribed certain limitations, had no idea of ignoring the real capital invested in the business. Corporations and partnerships are put in the same class in this respect. It is submitted that it would be quite inadmissible in giving a reasonable construction to these provisions, to hold that a corporation deemed to be within the Act, but having no capital stock, and having actual capital contributed by its members invested in its business, should be denied the right

to have that capital treated as invested capital when partnerships, without capital stock, and individuals, without capital stock, were entitled to have their contributions and actual capital so considered. It would be extraordinary, and it would seem to be wholly unreasonable, by virtue of such a construction, to reach the conclusion that the Act imposed a heavy war profits tax burden upon mutual life insurance companies whose investments never returned as much as six per cent. (R. 2) and on which it had made no war profits at all.

The definition of invested capital in Section 207, applying to corporations (save as excepted) without capital stock as well as to corporations with capital stock, applying to partnerships and individuals as well as to corporations, must be interpreted, we submit, as embracing cash contributions by members of mutual corporations for investment in the business, although there is no capital stock and no shares in the sense of stock or shares issued by corporations having capital stock. The excess profits tax Law was severe enough without construing it so as to justify arbitrary impositions outside the expressed intent of the Congress.

If the words "stock or shares" in subdivision (2) of Section 207 (a) could be regarded as qualifying the words "actual cash paid in" in subdivision (1) of Section 207 (a), is it not plain that these words must receive an interpretation broad enough to cover partnerships as well as corporations, and corporations without capital stock as well as with capital stock? They must receive an interpretation broad enough to carry out the policy of the Act which was intended to impose a like tax on individuals and allows to the individuals as investment in the business all cash actu-

ally paid in. Either (a) the Act does not apply to mutual companies without capital stock, or (b) the word "shares" must be taken to embrace the actual interests of the members in the assets of the corporation which are owned and held for investment in its business.

We submit that the foundation of the Government's argument, that, because the respondent had no capital stock, it can have no invested capital consisting of cash actually paid in by its members for investment, is unsound.

The Government refers (Govt's. Brief, p. 15) to the excess profits tax provisions of the Revenue Act of 1918 (Act of February 24, 1919, c. 18, sec. 326; 40 Stat. 1092). This case does not arise under that Act, and that Act cannot be regarded as an interpretation of the earlier Act of 1917 for a very simple reason.

The Revenue Act of 1918 constitutes a radical departure from the policy of the Act of October 3, 1917. By the Act of 1918, partnerships and individuals were no longer subjected to an excess profits tax. The new Act had a distinct policy and was confined to corporations (Regulations 45, Art. 701). The argument from the new Act so far as it relates to corporations is, indeed, against the Government's contention. We have seen what the words "stock or shares" must have meant under the prior Act, which applied these words to partnerships as well as to corporations, and to corporations without capital stock as well as to those with capital stock. The words "stock or shares" in the prior Act, as above stated, were not limited to stock or shares issued by corporations with capital stock. And if the words "stock or shares" in the new Act could possibly be taken to refer only to stock or shares issued by

a corporation having capital stock, this was manifestly a new policy. Such an Act cannot be treated as an interpretation of the former Act, but must be regarded as an amendment or change in the law. (*Provost* v. *United States*, 269 U. S. 443).

In the exceptions found in Section 207 of the Act of 1917, the Congress manifested no intention of excluding actual invested capital, the income of which was subject to taxation, for the purpose of determining excess profits during the war period, as compared with pre-war profits. The Congress excepted "assets the income of which is not subject to the tax" (Sec. 207, *supra*). This exception would seem to imply that the Congress intended to *include* assets held for investment in the business, the income from which *was* subject to the tax. The Congress excepted "money or other property borrowed" (Sec. 207, *supra*), but allowed the amount of cash paid in. Money *not* borrowed, representing an actual interest or investment in the business on which the tax income was earned, was not *excluded* but *included*.

"Surplus and undivided profits" are admittedly allowed as invested capital. But it would be incongruous to allow surplus and undivided profits and not to allow actual capital contributions by members of a corporation, having no capital stock, when it was through the investment of such contributions the surplus and undivided profits were earned. It would be wholly inconsistent with the policy and terms of the Act so to reduce "invested capital" by excluding such contributions, and thus artificially to increase profits to a high rate when in fact the return on the investment was less than six per cent. and the return had not at all been affected by war conditions.

The theory of the Government excludes all invested capital in the case of a corporation having no capital stock, unless it is surplus or undivided profits. As the corporation without capital stock makes its profits by investing its actual capital contributed by its members, the elimination of this capital investment in the calculation gives a small base and may, as in this case, vastly heighten the calculated rate of return, represented by net income which is actually earned by the real capital. Thus, in the case of a corporation without capital stock, but having investments of capital actually contributed by its members, a corporation with a relatively small surplus or undivided profits and thus presenting a small base for the calculation on the Government's theory, would have a relatively high excess profits tax, while a corporation of this character with a large amount of surplus and undivided profits would have a relatively low excess profits tax. The corporation might make only five per cent. on its actual capital invested in its business, but if the allowed invested capital was only the amount of its surplus and undivided profits, the less this amount the greater the excess profits tax.

Judge Rellstab pointed this out (R. 34; 295 Fed. pp. 890, 891). In referring to the case of a mutual life insurance company, he said:

> "The company which kept its premiums closest to the mathematical computation of cost would have the smallest surplus—Commissioner's invested capital—the largest earnings *pro rata*, and pay the largest excess profits tax, while the company which secured the largest surplus through a liberal loading of the premiums would obtain the smallest earnings *pro rata* and pay the smallest excess profits tax. In

> the absence of compelling reasons such an incongruous and inequitable result is not to be imputed to Congress."

Thus, if the invested capital of the respondent, on the Government's theory, that is, its undivided profits had been only $1,000,000, the net income (after deducting all that could be considered as earned on the eliminated amount of undivided profits) would still have been over $1,000,000, and the excess profits tax, on this theory, would have been calculated on the assumption that the company had earned more than 100 per cent. on its undivided capital. The company would have been made liable for an enormous excess profits tax under the higher brackets, which ran as high as sixty per cent. under the Act of October 3, 1917, on the excess profits over thirty-three and a third per cent. of the calculated "invested capital" (Sec. 201).

We submit that the fair construction of Section 207, in its application to corporations having no capital stock, is to permit actual contributions by members for investment and mutual profit, the actual cash paid in for this purpose by the members, not being borrowed money or assets the income from which was not subject to the income tax, to be treated as "invested capital" and on this basis to determine whether excess profits have been made during the war period, and presumptively due to war conditions, as compared with the profits made during the pre-war period.

The question then is of the *character* of the assets in question which have been excluded by the Commissioner from the considerations in the calculation of the "invested capital" of respondent. It is inadmissible to say that if the assets have the character of capital, they must be ex-

cluded simply because a mutual life insurance company has no capital stock. It is inadmissible to say that the only "invested capital" such corporation can have must be found in "surplus and undivided profits". If the assets in question, which the Commissioner has excluded, were paid in by the members of the respondent for investment in the business and mutual profit, as well as protection, and are in truth capital, then it is submitted that there is no statutory ground for eliminating them from consideration in calculating the excess profits tax.

Not only does invested capital embrace, under Section 207, "actual cash paid in", that is the contributions which form the basis of the enterprise, but also "*paid in or earned surplus and undivided profits used or employed in the business,* exclusive of undivided profits earned during the taxable year". It clearly follows that the assets of a mutual life insurance company which consist of the amounts earned upon the contributions of the members, and which are owned and held for investment in the business, are not excluded by the statute from being treated as "invested capital".

On January 1, 1917, the respondent possessed, in addition to $70,000,000 of premiums paid in, about $116,000,000 of assets which represented the amount earned upon the Company's investments in previous years (R. 4). We find no suggestion in the Government's argument that a mutual life insurance company cannot have "earned surplus" used or employed in the business, or that it cannot have "undivided profits" used or employed in the business. Admittedly, these categories apply to mutual life insurance corporations. It is understood that even the Treasury Department has always considered that a mutual life insurance

company can have both "earned surplus" and "undivided profits". The question is simply as to the way in which earned surplus and undivided profits shall be computed. The contention is not that because a mutual life insurance corporation has no capital stock it cannot have both "earned surplus" and "undivided profits", but that it is not entitled to consider certain assets, upon which the income is earned, which the Government treats as subject to the tax, as coming within either category, although these assets are held for permanent investment and represent an increment gained through the investment of the members' contributions.

We repeat, then, that if the assets which the Government has excluded in its computation were held for investment in the business and mutual profit as well as protection, whether these assets consisted of the amounts originally contributed or were the result of the investment of these contributions, there is no statutory ground for refusing to consider them in calculating the excess profits tax.

SECOND. The legal reserve of a mutual life insurance company consists of assets contributed by the members of the corporation for investment as well as protection, together with assets earned on such investment and re-invested. These assets, invested in the business and forming the basis of the enterprise, are in fact, and under the statute, invested capital. The reserve is not an indebtedness.

Respondent conducts its business on the *level premium* plan, whereby during the policy period that part of the premium to be paid annually to meet death losses is an

average of the low natural premium in the early years and the high natural premiums in the later years of life, thus avoiding the necessity of prohibitive premiums as the probability of dying increases with advancing years.

The average premium so estimated, increased by an allowance for cost of conducting the business, is uniform throughout the life of the policy (R. 2, 3).

Mutual Benefit Life Insurance Co. v. *Herold,* 198 Fed. 199; 231 U. S. 755;
Penn Mutual Life Insurance Co. v. *Lederer,* 252 U. S. 523;
New York Life Insurance Co. v. *Styles,* L. R. 14 A. C. 381;
Connecticut General Life Insurance Co. v. *Eaton,* 218 Fed. 188;
Connecticut Mutual Life Insurance Co. v. *Eaton,* 218 Fed. 206;
Fuller v. *Metropolitan Life Insurance Co.,* 70 Conn. 647.

The laws of all the States require of every life insurance company as a condition precedent to the continued transaction business that its assets shall not be less than the legal reserve. The amount of legal reserve is calculated annually by the supervising commissioners, and by the companies, and is based on an assumed rate of mortality formulated from long experience and an assumed rate of income from invested funds conservatively estimated at a low rate.

Conservative companies maintain assets somewhat in excess of the "legal reserve", in order to meet contingen-

cies, such as a fall in the market value of securities, or an abnormal increase in mortality due to war and pestilence, both of which were experienced to an unusual degree in connection with the late war. This margin of safety over reserve requirements is called a "contingent reserve" and the amount of it is in the discretion of the directors based on experience and forecast. These two reserves—one required by law, the other discretionary—comprise the entire assets of the respondent which are held for investment and are invested under statutory restrictions in government, municipal, railroad and utility bonds, bonds secured by mortgages on real estate, loans on collateral and to policyholders and the necessary office building. The average rate of interest on respondent's invested assets is and for many years has been less than six per cent. per annum (R. 2).

Respondent's assets are not segregated or earmarked or specially allocated to either of these reserves. Nor are they separately invested. There is no requirement of law or sound practice that requires such allocations, nor is it practicable in view of the fluctuating market value of the assets, which would require a constant shifting of assets from the legal reserve to the contingent reserve and *vice versa*. The assets, therefore, constitute one general fund. The interest earned on all its securities, except those which because of their character are specifically exempt from tax, is included in respondent's return of income for federal income tax purposes (R. 3).

The calculation of premium rates for life insurance involves first, the adoption of a table of mortality showing the estimated death rate for each age of life; second, the

adoption of an assumed rate of interest such as the Company may safely expect to realize upon its invested assets during the lifetime of the policy. These two factors determine what is technically known as the net or mathematical premiums, which are the sums sufficient to pay all outstanding policies as they become claims, provided deaths occur exactly in accordance with the table of mortality, and the rate of interest earned on the investment of such premiums is exactly equal to the interest rate assumed. To the net or mathematical premiums there is added a sum technically known as "loading" for the purpose of meeting the expenses of conducting the business as well as any unforeseen contingencies, such as an abnormal death rate due to war or pestilence. The net or mathematical premiums, increased by the "loading", constitute the premium rates stipulated in the policies of insurance.

Premium rates so computed, are, in the experience of life insurance companies, generally found to be in excess of their requirements. In a mutual company such excess constitutes its margin of safety and should be liberal. Such a company has no capital stock and must rely entirely upon its premiums as the contributions of its members, invested in its business, and available to meet unusual contingencies. These contributions must be sufficiently large to give protection and they also constitute a fund of the members for the purpose of investment. The policies of the company may run for a period of fifty or even seventy-five years and the stipulated premium cannot be increased after the policy is issued. In computing their rates the companies use, therefore, a table of mortality showing an admittedly higher death rate than that which will probably be realized. Policyholders are selected from an examined class of risks.

The assumed rate of interest on investments is also lower than that which the company expects to realize. The provision for expenses and contingencies is greater than would ordinarily be required. Mutual companies have these three margins of safety and normally, and in accordance with expectation, each assumption is in excess of what is actually required.

At the end of each year the excess of receipts over disbursements is ascertained, and after setting aside so much of such excess as is required by the increase in policy reserves and other provisions, including the contingent reserve, the balance is held for refund to the policyholders. Each policyholder's share in this sum is then ascertained, and, before his next premium falls due, he is advised of the amount of the refund of premium due him and that the Company will accept in full settlement of his next premium the difference between the premium written in his policy and the amount of this refund.

In the instant case the calculation of the legal reserve, as shown in the schedules annexed to the complaint, is on the basis of the American Experience Table of Mortality and three per cent. interest. But, as already stated, the actual mortality would be less than that thus estimated and the return on investments will normally be more than three per cent. So that in fact the legal reserve, apart from the contingent reserve, always represents much more than the amount sufficient upon reasonable expectations to meet all outstanding risks.

While the corporation continues its business, the assumption is, as borne out by the experience upon which the corporation bases its calculations, that the premiums re-

ceived in a given year with the earnings on investments will always be more than the amount necessary to cover the claims which mature during the year on the outstanding policies as well as the amount which may be required for proper reserves.

In a continuing business, with policies maturing, or surrendered, and with new policies issued, it is the expectation, and experience shows that it will be the result in a business conducted on such calculations as have been described, that the reserve will always be intact. It is true that as policies mature or are surrendered, the assets said to compose the reserve with respect to such policies, need no longer be regarded as reserved, and, on the other hand, each year from the amount received as premiums and interest additions are made to the reserve. The net addition to the reserve in any year is, of course, determined after allowing, or deducting, the amount no longer required to be held in reserve with respect to policies matured, or surrendered, and discharged in that year. But the premiums received in each year with the interest on the investment is expected to be sufficient to pay all the amounts payable on policies in that year and to provide the required addition to the reserve.

It would be a most extraordinary situation in which the legal reserve of a mutual life insurance company properly conducted on a level premium basis would be impaired. For example, in this case, we have, as an admitted fact, the yearly net additions to respondent's reserve, shown in Schedule F annexed to the complaint (R. 3, 10). These yearly net additions appear from the year of the respondent's incorporation, that is, 1845, to and including the year 1917. Thus, we have a history of the reserve of the re-

spondent for about seventy-two years. On examining this record (R. 10) we find the amounts carried to reserve from premiums and from interest each year, and the total reserve at the end of each year. It will be observed that this total reserve which the company has maintained has increased from $20,252.63 in 1845 and 1846 to $200,815,927 at the end of 1917. It will also be noticed that the amount of the reserve at the end of each year was always greater than it was the year before, except in the years 1861 and 1862 when there was a reduction of the reserve; in 1861, of about two per cent., and in 1862, of less than ten per cent. In all the other years the reserve at the end of each year was greater than it was at the beginning of that year.

Thus, with the exception of two years in the Civil War, the assets constituting the legal reserve of the respondent have been, as according to its calculations they were intended to be, a permanent fund with annual increments and not diminished either by the payment of policies maturing in each year or by the expenses of each year.

On January 1, 1917, the respondent's legal reserve was computed at $186,258,796. Of this sum, about $70,000,000 consisted of premiums paid in by its policyholders and about $116,000,000 consisted of interest earned by its invested funds.

The legal reserve considered as a fund consists simply of assets, intended to be permanently invested in the enterprise from which an income is annually derived for the corporate purposes.

This fund, we submit, is a capital investment.

In *Penn Mutual Co.* v. *Lederer*, 252 U. S. 530, 534, this Court said:

"On the other hand, the service performed in level-premium life insurance is both protection and investment. Premiums paid—not in the tax year, but perhaps a generation earlier—have earned so much for the coöperators, that the company is able to pay to each not only the agreed amount but also additional sums called dividends; and have earned these additional sums, in part at least, by transactions not among the members but with others; as by lending the money of the coöperators to third persons who pay a larger rate of interest than it was assumed would be received on investments. The fact that the investment resulting in accumulation or dividend is made by a coöperative as distinguished from a capitalistic concern does not prevent the amount thereof being properly deemed a profit on the investment. Nor does the fact that the profit was earned by a coöperative concern afford basis for the argument that Congress did not intend to tax the profit."

If a mutual life insurance company which has thus maintained such a legal reserve, decides to terminate its business then, of course, its assets, the company being a mutual one, will be treated on liquidation as belonging to the members who have contributed them, and these members will receive their appropriate shares or proportionate interests. These shares or interests are not in the nature of matured claims on policies. If there are such matured claims, those who hold them would, in the process of liquidation, be entitled to be paid first before the distribution among the members, that is, among the policyholders who had not withdrawn from the company and whose policies had not matured.

Mayer v. *Attorney General*, 32 N. J. Eq. 815.

From these considerations, it appears:

(1) **The title to the assets which are equal to, or are said to compose, the legal reserve is in the corporation.**

The rights of members of a mutual life insurance company are determined by the contract of membership. The rights and title of members in a mutual life insurance company are as distinct from the rights and title of the corporation, as the rights and title of stockholders are distinct from the rights and title of the corporation having capital stock.

The assets which are said to compose the legal reserve are not segregated. The title to these assets, that is the ownership, is just as completely in the corporation as the title or ownership of any other assets. When it is said that the assets of a mutual life insurance company belong to its members, it is meant that they belong to the members in the sense that in a stock company, the assets belong to the stockholders (*Mayer* v. *Attorney General,* 32 N. J. Eq., 815, 822). As members, the policy-holders manage the business through their agents, the directors, whom they exclusively have the power to elect (*id.,* p. 820). In stock corporations, the stockholders have that right; in a mutual company, the policy-holders, as the members of the corporation (*Penn Mutual Co.* v. *Lederer,* 252 U. S. 523, 535). But neither the stockholders in the one case, nor the members of the mutual company in the other case, have title to the assets of the corporation, either in law or in equity.

(2) **The legal reserve is not "money or other property borrowed".**

The assets equal to, or composing, the legal reserve are derived from premiums and the increment is obtained

through investment. The premiums are not borrowed and the increment is not borrowed. The premiums are paid under a contract by which they constitute contributions by the members of the corporation. The corporation enters into a certain engagement; but this engagement does not involve an obligation to pay back the premiums. The undertaking of the corporation is to pay a given sum on a given event. When the event happens, and not before, the company must pay. Until it happens, the undertaking is a contingent one; the contingency may never happen. If the policy is for a definite term, it is payable in case of death within the term. If it is an ordinary life policy, it must be in force when the death occurs, and, in the meantime, the premiums must be paid.

On the maturity of the policy, whether for a term or for life, the amount payable by the company is fixed by the policy and is not the amount of premiums which have been paid. In Schedules D, E and F annexed to the complaint to show the methods of calculating the reserve (R. 8 and 9) the illustration is given of an ordinary life policy of $1,000 issued at the age of thirty-five. It appears that at the end of the first year, although the policy is for $1,000 the reserve is only $12.88; at age forty, the reserve is only $82.94.

The policyholder, while he continues a member of the corporation, has no right to withdraw any part of the reserve. This is admitted (R. 4, par. 7). On ceasing to be a member of the corporation and surrendering his policy for cancellation, he may, ordinarily, at his option, receive a certain sum in cash or in paid-up policy in reduced amount or extended insurance for the full amount of the limited period. Any allowance thus made is never in ex-

cess of the reserve. It is generally less, and in some circumstances no allowance at all is made. This is also admitted (*id.*). No interest is paid upon the premiums contributed. No action for the recovery of these premiums can be maintained by the members.

It thus appears that there is no obligation on the part of the corporation to repay the amounts paid in as premiums. The premiums cannot be treated as money borrowed. The assets equal to, or composing the legal reserve, derived from premium payments and the invested funds are not money or property borrowed.

(3) **The fact that the reserve in question is required by law does not alter the quality of the assets which compose it.**

There are requirements of laws that corporations engaged in certain businesses shall have a stated amount of capital. There are legal provisions requiring deposits of securities with state officers. These requirements are intended to afford security to those who deal with the corporations. The funds thus maintained are to give assurance of safety. But the fact that these funds are thus required and maintained does not deprive the assets which constitute them of the quality of capital. On the contrary, they are subscribed, contributed and maintained as capital for the very purpose of complying with the law and giving the necessary foundation for the business undertaking.

It is of the essence of capital that it is the basis of the enterprise. It is the presence of capital that gives security. Certainly the fact that there are assets which afford protection and security does not deprive them of the characteristics of capital.

What should be the capital in a given enterprise, what amount should be required by law, in case of a public interest demanding such supervision, to be invested in the enterprise in order to afford security or a proper basis for the conduct of the business, depends upon the nature of the business, upon the engagements contemplated in the business, upon what experience shows to be needed for the safe conduct of the enterprise.

The point is that what the law requires is not the less capital simply because the law requires it.

(4) **The legal reserve is not an indebtedness.**

As the corporation is not bound to refund the amounts paid in as premiums, as these amounts are not borrowed money, as the corporation does not owe these amounts, the portion of the assets, derived from these premiums, which is held in reserve, cannot be regarded as an indebtedness. The corporation does not *owe* the premiums to anybody, and, of course, it cannot be said that the corporation *owes* the amounts earned by the investment of the premiums to anybody.

The corporation has made its agreement in its policies. But this agreement does not constitute either the premiums or the increment through investment on the premiums an indebtedness. And as the reserve is made up of these, the reserve is not an indebtedness.

It is urged that the legal reserve is carried by the companies as a liability; that it appears on the liability side of the ledger. But so is capital stock in the case of a corporation having capital stock. So is surplus. The principles of bookkeeping require that assets be balanced by corresponding entries on the liability side. The fact that

the legal reserve may be carried in accounts or reports as a liability does not mean that it constitutes an indebtedness. It does not mean that it is in a different legal category from contributions to capital which are always carried as liabilities.

The Government urges that the legal reserve is a "present existing liability." If so, someone must be able to enforce it. But there is no member, or policyholder, of the respondent who has any such claim. The respondent has been in business since 1845, but its legal reserve has been intact and constantly increasing; it has grown, as already pointed out, from $20,000 to over $200,000,000. During all these years, there never has been any person entitled to recover any part of it. Policy-holders have come and gone; they have been born, insured and died, but not one of them has ever had a cause of action for any part of the reserve. The respondent has never owed any part of the reserve to any one of them. The reserve has always been a permanent fund, contributed to, increased and maintained as such, which has enabled the policy-holders, members of the corporation, to feel perfectly secure—not because they were entitled to receive any part of the fund, but because the foundation of the business was unimpaired, and so long as the business continued without some very extraordinary loss, (of a sort not encountered in over 80 years) the company would be able to pay its losses on policies, or matured claims, each year out of the moneys received in that year, while at the same time, as against all contingencies, the basis of the enterprise would remain in a volume of assets which abundantly secured it.

The Government seems to argue that because death is certain the legal reserve of a mutual life insurance com-

pany is a present existing liability. But the policyholder in the case of an ordinary life policy must keep his policy in force in order that the amount payable on death may be recovered. If he withdraws from the company or surrenders his policy, what he generally receives is less than the reserve and in some cases he receives nothing (R. 4).

It is strikingly inaccurate to say that the reserve constitutes a "present existing liability".

The fact that there are assets in hand to meet emergencies does not mean that these assets are not capital. In fact, it is of the essence of capital to meet emergencies. It is contributed for this very purpose. In businesses where the public interest seems to demand it, capital is required in order that contingencies may be met.

Where a corporation, like an insurance corporation, receives large amounts of money from the public, it has been regarded as sound public policy to require the company to hold assets which will constitute the enterprise a safe one at all hazards. But it does not follow that the assets thus acquired by a corporation constitute an indebtedness, or that the amounts which it thus receives, owns and invests, and for which it is not indebted, does not constitute invested capital.

The question in the present case is whether the reserve constitutes an indebtedness. It is composed of assets owned and held for investment. These assets are contributed, not lent, to the corporation. They are contributed by the members. None of these members or policyholders has any cause of action to recover them.

We submit that no amount of discussion can alter the fact that the reserve consists of assets and not debts. Matured policies are claims. All that the respondent owes are

taken care of before we come to consider the assets in question. These assets are accumulations, which are reserved, not owed. They are balanced in the ledger by the reserve, but only after all indebtedness has been separately debited.

(5) The fact that several States, including New Jersey, tax life insurance companies only on the excess of their assets over their legal reserves does not make these reserves an indebtedness.

This practice is a special statutory concession to insurance companies in order to avoid what would otherwise be oppressive taxation deemed to be opposed to the public interest.

Thus, in *People's Fire Insurance Company* v. *Porter*, 35 N. J. Law 575, 579, 580, the Court said:

> "The Act of March 24, 1864, which relates to corporations whose business is that of insurance on lives, is a peculiar statute, for a favored class, and the allowance of deductions of the present value of policies, as a part of the liabilities of such companies, is distinct from the claim here made for allowance and deduction of what are called unearned premiums. It is certainly an exception from the general policy of the statute in taxing private corporations."

And in *Newark* v. *State Board of Taxes*, 81 N. J. Law 416, 421, the Court said:

> "The right given by the statute to the company, to deduct from the amount or value of its property the amount of its liability on its policies, is, in its essence, a grant of exemption from taxation; and it is a fundamental rule in the law of taxation that such grants will never be permitted to extend, in scope, beyond what the terms of the concession

clearly require, and that all doubts as to the scope of the exemption must be resolved in favor of the state."

Some jurisdictions have held that the explicit language of the taxing statute exempted a sum equal to the required reserve. Other jurisdictions have held that these assets are not exempt from taxation. The rule is that in the absence of a statutory granting of exemption, the total sum of assets possessed by the Company is subject to the tax.

In *Sun Mutual Life Insurance Company* v. *Mayor,* 8 N. Y. 241, a mutual insurance company was authorized to accumulate a fund which should be liable for losses during the term of its existence. The company was held liable to taxation upon the capital so accumulated. The Court said:

> "The statute under which the plaintiff organized, provides, that when applications to the amount of $500,000 shall be received, trustees may be chosen, that premiums paid in the first instance shall constitute the assured stockholders, and shall never be withdrawn from the company. This fund, although permanent and liable for all losses and expenses of the corporation during the continuance of its charter, is not, it is said, capital, because it was not constituted with a view to profit, but as the price of indemnity; capital, we are told, being money invested in business, with a view to profit. * * * The answer to it is, that the premiums are advanced by the persons seeking insurance with a view both to indemnity and profit.
>
> "By the payment of the premium the assured is entitled to indemnity and the same act constitutes him a stockholder, and in that capacity he acquires a new interest in the fund he has parted with, for a

full consideration. The money becomes capital to the company of which he is a member, to be used in sustaining its credit in paying losses, in investment by way of loan, the proceeds of which are ultimately to be divided among the stockholders.

"Again, it is said that the profits are not capital, and therefore cannot be taxed as such. This may be conceded as an abstract proposition, but the appellants must go farther and prove that profits cannot be made capital, either by contract or the act of the legislature, * * * and in the case before us the legislature has provided for an accumulation to the amount of $500,000; and, in addition, the agents of the corporation, in 1846, determined by a formal resolution, as they rightfully could do, that no division of the profits should be made until the accumulated earnings should exceed one million of dollars. These accumulations became capital, and liable for all debts of the corporation. * * * Under the old system, the capital was paid in, in whole or in part, by a time designated. In mutual companies, on the contrary, contributions may be made, from time to time, to the capital; and an interest, not merely derivative but original, acquired in it, so long as they continue to transact business."

In *People* v. *Board of Supervisors of New York,* 16 N. Y. 424, a mutual life insurance company was authorized by its charter to accumulate from premiums received and from the profits of their investment a fund to continue liable for its losses during the term of its existence. It was *held* that the accumulation of premiums and profits made by the company was capital within the provisions of statutes taxing corporations.

In *People ex rel. National Surety Company* v. *Feitner*, 166 N. Y. 129, it was *held* that a fund described as a reinsurance reserve required by law, being the amount necessary to reinsure outstanding risks which had become the absolute property of a company guaranteeing the fidelity of persons holding positions of trust, without any liability on its part to return any portions of the premiums paid, and subject only to liabilities which might arise from outstanding contracts, did not represent an indebtedness of the company which could be deducted for the purposes of taxation. The Court said (p. 135):

> "While it is apparent that the relator has not in fact 'just debts owing by' it equal to fifty per cent of the unearned premiums, our attention is nevertheless invited to that portion of the General Insurance Law under which relator is organized, which provided the method by which the solvency or insolvency of a company is determined, and the point is made that for that purpose at least 'a sum equal to the total unearned premiums on the policies enforced' must be charged as a liability. True; and it also requires that for such purpose the capital stock shall also be charged as a liability. But it will not be claimed that the capital stock may be treated as a debt to be deducted from the company's assessable assets on that account, and of course no stronger argument can be made in support of a claim that the statute intended to have unearned premiums that are really an asset of the company treated as a debt for the purposes of assessment."

In *Republic Life Ins. Co.* v. *Pollak*, 75 Ill. 292, it was held that the reassurance reserve and premiums of life insurance companies being collected are subject to taxation as

they are claims and funds that would be taxable in the hands of a natural person.

In *City of Portland* v. *Union Mutual Life Ins. Co.*, 79 Me., 231, it was held that under a statute making all personal property with certain exceptions taxable to the owner in the town where he is an inhabitant, a mutual life insurance company is legally taxable, in the town where its principal place of business is, for the stocks, bonds and other securities or personal property in which its funds and annual earnings have been invested. And such earnings and the premiums received from its policy holders were not considered as "personal property placed in the hands of the corporation as an accumulating fund for the future benefit of heirs or other persons," and, therefore, are not within the exceptions named in the statute. The Court said:

> "The contract of life insurance is not a deposit of the premiums to be paid to some person with their accumulations at some future time, but a special contract of hazard for the payment of a sum stipulated without regard to the amount paid in premiums before the happening of the contingency."

The case of *Kansas Mutual Life Association* v. *Hill*, 51 Kans. 636, 33 Pac. 300, held that the reserve fund of a mutual life insurance company organized on the cooperative plan and having no capital stock was subject to taxation. The court specifically decided that the reserve of such an insurance company was not an indebtedness which it was entitled to deduct from the credits of the company subject to taxation. The Court said:

"The general rule is, that all property must bear its share of taxation, unless expressly exempted therefrom. There are no stockholders in this company to be taxed on their stock. No policyholder has a fixed right to any definite portion of the funds of the company. The ownership of all its assets of every kind is in the company alone. It is true that it has contingent liabilities, and is, in a sense, a trustee of the funds in its possession, but the beneficiaries of the trust are not yet determined except as to the $10,000 of losses already accrued. Each and any of the policyholders may forfeit their rights in the fund by failure to pay their assessments, and many of them probably will. A contingent liability which is not susceptible of computation is not a debt owing in good faith which may be deducted from credits under the tax law, and we fail to find anything in the statutes indicating that it was the intention of the legislature that the reserve fund of an insurance company should be exempted" (pp. 649-650).

In *Commonwealth Life Ins. Co.* v. *Louisville,* 145 Ky. 284, 140 S. W. 306, the Kentucky Court of Appeals held that securities deposited with a State Treasurer by a life insurance company for the benefit of policyholders and as a condition of its doing business in that state, were taxable locally on the ground that they belonged to the company, and that the policyholders had no lien thereon.

The Court said:

"* * * They are not deposited with the State Treasurer to the credit of any particular policyholder, nor has any particular policy-holder any claim to any of them above that of all other policyholders. When the company comes to pay a policy

> or give a policy-holder the net cash balance of his policy, it does not necessarily raise the sum to be paid from the securities deposited with the State Treasurer. In the ordinary course of its business, it satisfies the policy-holder out of other funds in its possession. * * * The securities on deposit with the State Treasurer are not liable for the debts of the company to a greater extent than is any other property owned by it. So far as its liabilities are concerned, all of its property occupies the same position. It is all charged with the payment of liabilities" (p. 288).

And in distinguishing between such deposits of securities and deposits in a bank, the court said:

> "But the attitude of an insurance company towards the securities placed by it with the State Treasurer is very different from the attitude occupied by the bank towards its depositors. The securities on deposit with the State Treasurer before they are deposited belong absolutely to the insurance company, subject to the payment of its debts. They continue to be its property subject to the payment of its debts. At no period, has the policyholder any interest in these securities, except to the extent that they may be necessary to satisfy the conditions of his policy. At no time can the policyholder demand that any of these securities shall be turned over to him, or sold for his benefit, unless it should be that the company was in process of liquidation."

In many jurisdictions the reserve is not treated as a liability for purposes of local taxation; in the cases cited by the Government, it is only so treated by special provision of law as an appropriate concession to the business of life insurance; and it is, therefore, submitted that this conces-

sion should not be a precedent for a ruling adverse to insurance companies in applying a statute defining capital for the purposes determining whether they have made excess profits through the war.

(6) **The legal reserve is not a trust fund.**

Many years ago the doctrine was laid down that the assets of a corporation were a trust fund for the benefit of its creditors. But, of course, this did not mean that the creditors in the case of a solvent corporation were *cestuis que trustent.* In the case of an insolvent corporation it meant substantially that the creditors' rights were superior to those of the stockholders. Of course, the policyholders of a mutual life insurance company are members, not *cestuis que trustent.* They have rights under their policies, but the company is not a trustee and the assets of the company are not trust funds. If it is meant that directors, the agents of the members of the corporation, must perform their duties under the law, or that in case of liquidation there must be an equitable distribution, there is no objection to the doctrine, but it in no way alters the fact that the assets in question belong to the corporation and have been contributed for investment in the business and constitute a reserve having the characteristics of invested capital.

The contention that the relationship of a mutual company to its policyholders is that of trustee has not found favor with courts, and is expressly disapproved in *Equitable Life Assurance Society* v. *Brown,* 213 U. S. 25 (1908).

> "They lay no foundation for the jurisdiction of a court of equity in such a case, unless it appears that the relation between the policyholder and the defend-

ant is that the latter is the trustee of the former by reason of the trust relation between them resulting from the insurance policy. The complainant's contention, as above stated, that there is such a trust in the fund mentioned has never been regarded as the law in the State of New York (*Cohen* v. *New York Life Insurance Company,* 50 N. Y. 610; *People* v. *Security Life &c. Co.,* 78 N. Y. 114; *Bewley* v. *Equitable Life &c.,* 61 How. Pr. 344; *Uhlman* v. *New York Life Ins. Co.,* 109 N. Y. 421; and, to the same effect, *Greeff* v. *Equitable Life Assurance Society,* 160 N. Y. 19), nor anywhere else so far as any case has been cited on the subject.

"In the *Uhlman case, supra,* the plaintiff was the owner of a policy known as a ten-year dividend system policy, otherwise a 'tontine plan' policy, which, it was averred, gave to the holder a special title to the funds derived from the payment of premiums on the policies of that kind and in the particular class to which the policy belonged. The Court of Appeals of New York held that such claim was not well founded; 'that it could not be said that the defendant is in any sense a trustee of any particular fund for the plaintiff, or that it acts as to him and in relation to any such fund in a fiduciary capacity. * * *' " (p. 46).

See, to the same effect:

Peters v. *Equitable Life Assurance Society,* 200 Mass. 579;

Equitable Life Assurance Society v. *Weil,* 103 Miss. 186;

Townsend v. *Equitable Life Assurance Society,* 183 Ill. App. 326;

Gourley v. *Northwestern Mutual Life Ins. Co.,* 94 Okla. 46.

THIRD. The assets equal to, or composing, the legal reserve are not within the non-inclusion clause of the statute.

The non-inclusion clause of Section 207 is as follows (40 Stat. 306):

> "As used in this title 'invested capital' does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title, nor money or other property borrowed."

It has already been shown that the assets which are equal to, or said to compose, the legal reserve are not "money or other property borrowed."

The remaining question then relates to "stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed."

(a) On December 31, 1916, the respondent had state and municipal bonds to the extent only of $4,171,901.33 and stock amounting to $17,250 (R. 7, Schedule B, annexed to complaint). It is manifest that a deduction of these amounts from the total invested assets would not reduce the invested capital so as to subject the respondent to the war excess profits tax.

(b) The inquiry then relates to "other assets, the income from which is not subject to the tax imposed by this title."

But the respondent has no such "other assets". We do not understand that the Government contends otherwise, but if it does, the argument is untenable.

The test as to the non-inclusion of any given asset is whether *the income from it* is excluded from the net income of a corporation as defined by Section 206 (40 Stat. 305) which provides that the net income should be ascertained and returned for the taxable year upon the same basis and in the same manner as provided in the Act of September 8, 1916 (39 Stat. 756) "except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations, joint stock companies or associations, or insurance companies, subject to the tax imposed" by Title I of the Act of 1916 "shall be deducted". This exception does not apply.

We are thus referred to the Act of 1916 to determine what are the assets the income from which is not subject to the tax imposed by the Act of October 3, 1917. Section 4 of the Act of 1916 (39 Stat. 758) provides that the following income shall be exempt from the provisions of this title:

> "The proceeds of life insurance policies paid to individual beneficiaries upon the death of the insured; the amount received by the insured, as a return of premium or premiums paid by him under life insurance, endownment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon the surrender of the contract; the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included as income); interest upon the obligations of a State or any political subdivision thereof or upon the obligations of the United States

> or its possessions or securities issued under the provisions of the Federal farm loan Act of July seventeenth, nineteen hundred and sixteen; the compensation of the present President of the United States during the term for which he has been elected, and the judges of the Supreme and inferior courts of the United States now in office, and the compensation of all officers and employees of a State, or any political subdivision thereof, except when such compensation is paid by the United States Government."

It is apparent that the income derived from the respondent's assets in question, is not exempted income under this provision.

All the income from respondent's investments (other than that from United States, State or municipal bonds) has been treated as gross income for the purpose of the income tax. After the statutory deductions, the tax is paid on the balance.

In determining net income, Section 12 (a) (39 Stat. 768) provides that in the case of an insurance company there may be a deduction from the gross income as follows:

> "Second. * * * (c) in the case of insurance companies, the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts."

Under this provision the respondent, in making its income tax return for the year 1917, deducted the amount of its payments on policies ($20,669,808.48) and its net addition to the reserve fund ($14,557,131).

These deductions do not bring the assets in question within the non-inclusion clause of Section 207 for the determining of invested capital.

The net addition to the reserve fund made in the year 1917 was not chargeable either by the law or in practice against the income from any particular fund. And, as Judge Rellstab observed (R. 32) "the net additions made in 1917 are not part of the legal reserve which the plaintiff seeks to have allowed as invested capital. This reserve is made up solely of net additions of preceding years."

According to the language and spirit of the Act, it is the *character* of the assets, and not the *use* to which the income is put, which determines whether it shall be excluded from invested capital. This is made plain by the context. The clause reads "stocks, bonds (other than obligations of the United States), or other assets the income from which is not subject to the tax," showing that it is the *source* of the income which is determinative. It is only when the income is derived from an exempted source that the exception applies. But, save with respect to State and municipal bonds, stocks, and the express exemptions of Section 4 of the Act of 1916, the income derived from the assets composing the legal reserve of an insurance company is not exempted.

The provision of Section 12 (a) of the Act of 1916 for the deduction of the net addition to the reserve fund, has no relation whatever to the provision of Section 207 of the Act of 1917 with respect to invested capital and to what should not be included therein.

To repeat, the assets composing the reserve fund, are not assets the income of which is not subject to the tax imposed, unless these assets are United States, State or municipal bonds or come within the provision which exempts them, above quoted. In the case of the respondent there were no assets which could be allocated to the legal reserve in question (save the United States, State and municipal bonds and the small amount of stock which was owned) which could be regarded as assets the income from which was exempt.

If the reserve is to be excluded from invested capital because earnings therefrom might conceivably be considered as making up a part of the net addition to the reserve, which is deducted from the gross income, it would be necessary, on the same principle, to deduct from invested capital such part of the assets, the income from which would equal the expenses of management, likewise deductible from gross income; and also a further portion of the assets, the income from which would be sufficient to equal the taxes paid which are deducted from gross income; also, funds sufficient to earn income equivalent to the $3,000 specific exemption provided in Section 203(a). This would be absurd. There is neither in the law nor in the practice of insurance companies any special allocation of assets to the various items deductible from gross income in determining the earned income tax.

If it be urged that in the calculations of life insurance companies it is assumed that the invested funds earn interest which is added to the reserve, it must be remembered that the statutory ascertainment of the reserve only assumes a three per cent. return, while, in fact, the plaintiff's investments yield about five per cent., so that even on

this theory at least a part of the income from invested reserves goes into net income for the purpose of the ordinary income tax.

The reserve is merely a yard-stick to determine whether the company has an appropriate basis for the conduct of its enterprise. The assets which are said to compose the reserve are the company's property, representing either cash paid in, or paid in or earned surplus and the income from all of these assets is returned as gross income for the purpose of the tax.

While the net additions to the reserve in the taxable year are deductible from the gross income of that year, these net additions form a part of the assets of the company held for investment, the income from which is the subject of the income tax in the ensuing years. So that while the net additions in each taxable year are deductible from the gross income of that year, the reserve itself as a continuing and increasing fund is always an investment the income from which is subject to the income tax.

Judge Rellstab called attention to the fact that whatever might be said as to the net additions to the reserve beginning with the year 1909, when the Federal Excise Tax on Corporations was adopted (36 Stat. 112), it could not by any possibility be said that the reserve which had been accumulated prior to that time constituted assets upon which an income tax had been in any sense escaped, for there was no such tax. Judge Rellstab pointed out that at the beginning of the year 1909 the total legal reserve was the sum of $110,124,750.07, and the interest derived therefrom was subject to the Federal income tax in that and subsequent years. He also observed that of the total re-

serve held on January 1, 1909, the sum of $33,569,887.14 was contributed from premiums and that this sum was an aggregate cash contribution by the members of the respondent to be used and employed by it in its business of life insurance.

Judge Rellstab also noted that the New Jersey Legislature first required life insurance companies to maintain a legal reserve in the year 1872; and that at the beginning of that year respondent's reserve amounted to the sum of $19,656,144 and that this sum, if added to the amount allowed by the Government as invested capital ($14,719,043.76) would bring the total of invested capital above the sum of $25,500,000, an amount concededly sufficient to avoid the imposition of any excess profits tax for the year 1917 (R. 36; 295 Fed. pp. 892, 893).

There is another point which in any view would seem to be controlling. The net addition to respondent's reserve during the year 1917 was $14,557,131. Of this sum $6,220,570 were derived from interest received in 1917 on the assets held at the beginning of the year and $8,336,560 from premiums received during the year (R., Schedule F, p. 10). The interest received by the respondent in 1917 amounted to $10,130,857 (R., Schedule C, p. 8). Only 61.402 per cent. thereof, or $6,220,570, was required for the addition to the reserve in 1917; the balance $8,336,560, as shown above, came from premiums received in 1917.

In imposing the tax in question, the Government based the amount of respondent's invested capital at the beginning of the taxable year, before making any deductions therefrom, at $201,486,566.

We have shown that all the assets of respondent, which can be said to compose the reserve, are subject to the income

tax (with few immaterial exceptions), and hence that there is no part of the reserve which falls within the non-inclusion clause. But, we submit, that if the Government could be justified in making any deduction from invested capital because of the provision that the addition to the reserve is deductible, the Government on any theory could not justify the deduction of any larger sum than an amount which could be said to earn the interest thus said to be exempt for the reason that certainly the interest earned on the rest of the assets was subject to the income tax.

It follows, therefore, that even under the Government's claim, all that could be excluded from invested capital would be 61.402 per cent. of the total assets of $201,486,566 which would be equivalent to $123,716,781, leaving $77,769,785 as respondent's minimum and indisputable invested capital for the purpose of the Act.

Taking seven per cent. thereof as the minimum deduction allowed by the Act, the respondent was entitled to an income of $5,443,885 before any war excess profits tax could be assessed. And as respondent's net income, as adjusted, was only $1,781,815, it is evident that on any possible view it would not be subject to any war excess profits tax.

FOURTH. The Government's claim is not aided by the capital stock tax act of 1916, but, on the contrary, the provisions and policy of that act support the respondent's contention.

The capital stock tax act of 1916 (39 Stat. 789) provides for the payment of a special excise tax for the privilege of carrying on business by corporations including insurance

companies. The Act specifically exempted the assets which constituted the legal reserve of insurance companies from this tax. Section 407 of that Act is as follows:

> "Provided, that in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of, or payment to, or apportionment among, policy holders, shall not be included."

The fact that in this Act the Congress specifically exempted the reserve from the provision of the excise tax indicates that the Congress thought that in the absence of such a specific exemption the reserve would be taxable. The failure of the Congress to exclude these assets which constitute the legal reserve from the definition of invested capital in the subsequent Act of 1917 shows clearly that there was no intention that they should be excluded. It will be observed that in the Capital Stock Tax Act the Congress did not refer to the reserve as an indebtedness. The exclusion was a concession evidently made in view of the benevolent character of insurance companies and in order to prevent the imposition of an exorbitant tax.

The Government cannot, in any event, invoke the capital stock tax act to aid its contention here, as it is apparent that the purpose of Congress in the imposition of the capital stock tax was a different one from its purpose in the imposition of the war excess profits tax. In the *former,* Congress was imposing an excise tax predicated on the fair value of the shares of stock, taking into consideration all elements of value—market quotations, net worth of assets, earning capacity, good will and any element of value conceivable. In assessing this tax, the earnings were treated

as one of the bases of current value, and the capitalization as a preferential basis of fair market value. (See Regulations 38, as revised August 9, 1918, Appendix A, Art. 1.) In the *latter,* Congress was imposing an excise tax on the invested capital—cash paid in and earned surplus retained —predicated on the income history of the corporation during the pre-war period and currently, so that excessive profits due to war conditions could be reached.

These different objects could not result in identity of capital under the capital stock tax act and invested capital under the war excess profits tax act, as is clearly pointed out in the Federal regulations applicable to the two taxes. We quote from Regulations 64 of June 15, 1922 (Art. 15):

> "The fair value of the capital stock, as provided under section 1000(a) (1) of the Revenue Act of 1921, and invested capital under the excess profits tax provisions of the Revenue Act of 1921 are not necessarily the same.
>
> "For the purpose of capital stock tax the fair value of the capital stock is estimated, and is predicated on present values, including actual appreciation of property, whether realized or unrealized, and such intangible assets as good will, trade-marks, and patents to the extent reflected by the earning power, whereas, for the purpose of excess-profits tax, the invested capital is based upon the actual investment of the stockholders in the corporation, irrespective of the present value of its assets. In the case of the capital stock tax the fair value looks to the present net value of the assets, irrespective of the amount of the investment of the stockholders."

It is therefore evident that under the theory applicable, and the regulations applied, in the assessment of the capital

stock tax, the assets equal to the amount of the reserve from which a large part of the earnings of the corporation are derived would be included, if not expressly excluded. The specific exclusion was, as suggested above, probably intended to prevent exorbitant taxation of life insurance companies.

The policy of Congress in furthering the object of life insurance companies in furnishing insurance at cost is achieved by this construction. The reserve is excluded in the capital stock tax act, thus reducing the tax and the cost of insurance to the policy-holders.

The reserve is included in the definition of invested capital thus precluding the assessment of a war excess profit tax unless all of the assets have yielded an exorbitant income and the cost of insurance is thus reduced to the member policyholders.

FIFTH. There is no distinction, in respect to the question here involved, between the reserve of a life insurance company and that of a fire, marine or casualty company.

The Government admits that the reserves of other insurance companies are to be treated as part of the invested capital under the war excess profits tax act, and these reserves have been so treated (Regulations No. 45, Art. 870).

The Treasury regulation provides:

> "The like reserve fund of insurance companies other than life insurance companies may be included in computing invested capital."

What possible ground there is for thus discriminating between *"like reserve funds"* we cannot understand.

It is said that a building may never burn, but that everyone must die. But death alone is not sufficient to give a cause of action on an insurance policy; the policy must have been kept in force. The death must have occurred while it is in force. This may not be. The building may burn and the owner may let his life insurance lapse.

Many life insurance policies are for a term of years. A large percentage of life insurance policies, whether for a term or for life, are not continued in force. The reserves in both life and fire companies are built up from the premiums paid in, are both required by State regulation, and are determined with equal exactness, with similar penalties for deficiencies (See 2 Comp. Stat. N. J. 2854, 56, 59, Secs. 56, 62, 70).

The distinction between fire insurance business and life insurance business does not help the Government, but rather the respondent. For, as this Court has pointed out, "The thing for which a fire or marine insurance premium is paid is protection, which ceases at the end of the term. If after the end of the term a part of the premium is returned to the policyholder, it is not returned as something purchased with the premium, but as a part of the premium which was not required to pay for the protection; that is the expense was less than estimated" (*Penn Mutual Co.* v. *Lederer*, 252 U. S., pp. 533, 534). In this view, treating the reserve of a fire insurance company as held exclusively for protection the argument would be stronger rather than weaker that it should be excluded from invested capital. On the other hand, this Court has pointed out in the same case that in level-premium life insurance the object of the

payments of premiums is both protection and investment. To quote again:

> "On the other hand, the service performed in level-premium life insurance is both protection and investment. Premiums paid—not in the tax year, but perhaps a generation earlier—have earned so much for the coöperators, that the company is able to pay to each not only the agreed amount but also additional sums called dividends; and have earned these additional sums, in part at least, by transactions not among the members, but with others; as by lending the money of the coöperators to third persons who pay a larger rate of interest than it was assumed would be received on investments. The fact that the investment resulting in accumulation or dividend is made by a coöperative as distinguished from a capitalistic concern does not prevent the amount thereof being properly deemed a profit on the investment."

In the case of a life insurance company, there is no basis for holding that these funds held for investment are not invested capital. The ruling of the Government that the reserve in the case of other companies should be invested capital destroys the foundation of its position that the reserves of life insurance companies should not be regarded as invested capital.

It should also be noted that the Congress specifically exempted the reserves of both classes of companies from the capital stock tax act.

SIXTH. Statements made in the course of hearings before the Committees of Congress are immaterial.

Such statements fall in the same category as statements in debates (*Duplex Printing Press Co.* v. *Deering*, 254 U. S. 443). The statements to which the Government refers in its brief were not contained in Reports of Committees and were not made with the responsibility of those entrusted in either House with the carriage of the measure.

The respondent is not to be made subject to the war excess profits tax because one of its officers urged the Senate Committee to modify the existing language.

It does not appear but that Committees, and the Congress, believed that the apprehensions of the respondent were groundless. Indeed when the fear was expressed that the Internal Revenue Department might construe the Act as excluding the legal reserve from the definition of "invested capital", Senator James, one of the three members of the Sub-Committee of the Senate Finance Committee, said: "I do not think that theory is very well grounded" (Hearings before the Senate Sub-Committee of Finance 64th Cong. 2d Sess. H. R., 20573, p. 53), and the other two members, by silence, may be taken to have acquiesced in that Senator's view. The statement was not reported to the main Committee nor by it to the Senate, nor is it important that an amendment of the law was sought. The construction of the Government was immediately attacked and this suit was brought. It may easily be concluded that the Congress thought that no amendment was necessary. Such a belief would have been justified with respect to the re-

serves of other insurance companies, and it is more than probable that the Congress did not conceive that the Government would take such an inconsistent position as it has taken with respect to reserves of life insurance companies.

We ask that the judgment be affirmed.

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SUPREME COURT OF THE UNITED STATES.

No. 108.—October Term, 1926.

Charles V. Duffy, Former Collector of Internal Revenue, Petitioner, *vs.* The Mutual Benefit Life Insurance Company.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[November 29, 1926.]

Mr. Justice Sutherland delivered the opinion of the Court.

This case arises under the Revenue Act of 1917, c. 63, 40 Stat. 300, 302-306, imposing upon every corporation, partnership and individual a war excess profits tax. The pertinent provisions of the Act are as follows:

"Sec. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

"Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year; . . .

"Sec. 203. That for the purposes of this title the deduction shall be as follows, except as otherwise in this title provided—

"(a) In the case of a domestic corporation, the sum of (1) an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period was of the invested capital for the prewar period (but not less than seven or more than nine per centum of the invested capital for the taxable year), and (2) $3,000;

. . .

"Sec. 207. That as used in this title, the term 'invested capital' for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.

"As used in this title 'invested capital' does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title, nor money or other property borrowed, and means, subject to the above limitations:

"(a) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year: . . .

. . ."

By § 200 it is provided that the term "corporation" includes joint-stock companies or associations and insurance companies, and we assume that this includes non-stock mutual insurance companies as well as those having capital stock.

Respondent is a mutual company having no capital stock; and its policyholders constitute its members. Its business has always been conducted upon the "level premium plan," under which the estimated annual cost of the insurance is averaged and the maximum annual contribution of each member is uniform throughout the life of the policy. The annual contributions during the early years of the policy are in excess of the natural premiums, and such excess premiums, augmented by interest thereon, are held as a reserve to maintain the insurance in the later years. These contributions (or premiums), together with the increment derived from their investment, constitute the sole assets of the company. A more complete statement of the plan will be found in the opinion of the district court in this case, 295 Fed. 881, and cases cited in that opinion at p. 883.

The company is required by state laws, as a condition of continuing business, to maintain its assets at a sum not less than the amount of the "legal reserve" required by such laws. For the year 1917 the legal reserve amounted to something over $186,000,000. In addition to the legal reserve, the company maintained a second or "contingent reserve" as a margin of safety to meet contingencies. The two reserves are not segregated in any

way or separately identified or invested. The funds therein, constituting the company's entire assets, are invested in its office building and in government bonds and other securities. The income resulting from the investments is returned for federal taxation and is taxed. For the year 1917 the sum of the two reserves was returned by the company as invested capital for that taxable year. The net income shown for the year was $1,808,339.33, upon which the company paid an income tax of $108,500.36, but no excess profits tax. The Commissioner of Internal Revenue amended the returns and, thereupon, levied an additional assessment against the company amounting to $83,779.70. This was accomplished, so far as necessary to be now considered, by deducting from the amount of invested capital as returned the sum of $186,258,796, being the exact amount of the legal reserve, and reducing the company's invested capital for the year to the sum of $14,719,043.76. It is agreed that if, instead of this latter sum, the company's invested capital had been computed at any sum in excess of $25,500,000, no war excess profits tax would have been due.

The company paid the amount of the additional assessment under protest and brought this action to recover it. The collector moved to strike out the complaint as insufficient in law. It was stipulated that the decision on the motion should be a final disposition of the controversy. The district court denied the motion and rendered judgment for the full amount with interest. 295 Fed. 881. This judgment was affirmed by the circuit court of appeals. 3 F. (2d) 1020.

The question for determination is whether the funds constituting the legal reserve, or sufficient thereof to make up as much as $25,500,000 when added to the amount allowed by the commissioner, is invested capital within the meaning of § 207 (a) of the Revenue Act. The contention of the collector is that under subdivisions (1) and (2), § 207 (a), invested capital must be either cash or tangible property paid in for stock or shares of the corporation, and inasmuch as the company has no capital represented by stock or shares, its legal reserve is not invested capital within the meaning of those subdivisions; that the legal reserve is not surplus or undivided profits within the meaning of subdivision (3), because it is no more than the equivalent of the obligations of the company at the time under its policies of insurance. It is contended that the legal reserve represents a present existing liability; and stress is put upon the

fact that it is carried by the company on the liability side of its ledger.

It appears from the complaint that the company has been in business since the year 1845. During that time the amount of its assets has increased, year by year, from about $20,000 in 1846 to over $200,000,000 in 1917, divided between the legal reserve and the contingent reserve, as already stated. The legal reserve includes $70,000,000 premiums theretofore paid and $116,000,000 earnings upon investments. The legal reserve, therefore, constitutes assets of a very permanent character. Originally consisting of the contributions of members only, the earnings now make up considerably more than one-half of the whole. The contributions were made for, and have been used to serve, the double purpose of protection and of investment. These assets, thus constituted, have never represented indebtedness any more than the capital of a stock corporation subscribed by its stockholders represents indebtedness. Until the maturity of a policy, the policyholder is simply a member of the corporation, with no present enforceable right against the assets. Upon the maturity of the policy he becomes a creditor with an enforceable right. Then for the first time there is an indebtedness. See *Mayer* v. *Attorney General*, 32 N. J. Eq. 815, 820-822. In the meantime, each member bears a relation to the mutual company analogous to that which a stockholder bears to the joint-stock company in which he holds stock. In either case, the title to the assets is in the corporation and not in the members or stockholders.

True, the amount of the reserve is carried on the books as a liability, but only as the capital stock of a stock corporation is carried on its books as a liability. In both instances, it is a form of bookkeeping to balance assets, which in the one case is contributed by the members, and in the other by the stockholders. If § 207 (a) subdivisions (1) and (2) had defined invested capital as "actual cash paid in," without more, it probably would not be doubted that the part of the legal reserve derived from premiums would be included. The doubt results from the use of the additional words "for stock or shares in such corporation or partnership." The collector says these words qualify the phrase "(1) actual cash paid in" as well as the phrase which they immediately follow, "(2) the actual cash value of tangible property paid in." For present purposes we shall assume this to be so—although there is

a plausible argument on the other side to the contrary—and consider the case accordingly. The mutual company is not a stock company, and the word "stock" may be put aside as having no application to it. It is clear that since the word "stock" does not describe interests in partnerships, included expressly along with corporations in the same paragraph, the word "shares" must be held to do so. And if that word is broad enough to include partnership interests, it is broad enough to include the interests held by members in non-stock corporations.

To hold the contrary would be to so limit the application of subdivisions (1) and (2) of § 207 (a) as altogether to exclude therefrom those corporations which have no capital stock. We cannot suppose that Congress intended such a result; but must conclude that it used the word "stock" as appropriate in the case of stock corporations and the word "shares" as appropriate in the case of partnerships and non-stock corporations. Such an interpretation does no violence to the ordinary meaning of the word, for while it is entirely proper to speak of "stock" as "shares" it is equally proper to designate the several interests in a common fund as "shares." To the extent of $70,000,000 the legal reserve consisted of "actual cash paid in" by the members. These payments were intended for investment, and were invested, to increase the resources of the company and thereby reduce the cost of the insurance; and it requires no stretch of the realities to say that, within the meaning of subdivisions (1) and (2), § 207 (a), the fund which they created is invested capital. This is enough to relieve the company from the payment of any war excess profits tax, and it is unnecessary to inquire whether the remaining $116,000,000 is to be regarded as earned surplus under subdivision (3).

Judgment affirmed.

A true copy.

Test:

Clerk, Supreme Court. U. S.